S. Hrg. 109–997

ASSESSING THE CURRENT OVERSIGHT AND OPERATIONS OF CREDIT RATING AGENCIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE CURRENT OVERSIGHT AND OPERATION OF CREDIT RATING AGENCIES

MARCH 7, 2006

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

39–602 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

RICHARD C. SHELBY, Alabama, *Chairman*

ROBERT F. BENNETT, Utah	PAUL S. SARBANES, Maryland
WAYNE ALLARD, Colorado	CHRISTOPHER J. DODD, Connecticut
MICHAEL B. ENZI, Wyoming	TIM JOHNSON, South Dakota
CHUCK HAGEL, Nebraska	JACK REED, Rhode Island
RICK SANTORUM, Pennsylvania	CHARLES E. SCHUMER, New York
JIM BUNNING, Kentucky	EVAN BAYH, Indiana
MIKE CRAPO, Idaho	THOMAS R. CARPER, Delaware
JOHN E. SUNUNU, New Hampshire	DEBBIE STABENOW, Michigan
ELIZABETH DOLE, North Carolina	ROBERT MENENDEZ, New Jersey
MEL MARTINEZ, Florida	

KATHLEEN L. CASEY, *Staff Director and Counsel*
STEVEN B. HARRIS, *Democratic Staff Director and Chief Counsel*
MARK OESTERLE, *Counsel*
JUSTIN DALY, *Counsel*
DEAN V. SHAHINIAN, *Democratic Counsel*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
GEORGE E. WHITTLE, *Editor*

C O N T E N T S

TUESDAY, MARCH 7, 2006

ASSESSING THE CURRENT OVERSIGHT AND OPERATIONS OF CREDIT RATING AGENCIES

TUESDAY, MARCH 7, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Good morning to everyone. Today, the Banking Committee continues its review of credit rating agencies. These entities wield extraordinary power in their role as gatekeepers to the bond markets. Although the rating business has existed for almost a century, recently there has been a renewed interest in how the industry operates and how it is regulated due to its increased importance in today's markets and because of the well-publicized failures to warn investors about the bankruptcies at Enron, WorldCom, and other companies.

The modern rating industry was established in 1975 when staff of the Securities and Exchange Commission first issued no-action letters, essentially regulatory license to a select number of rating firms. With the addition of only a few more firms, these nationally recognized statistical rating organizations, or NRSRO's, have since provided almost all of the ratings used in the markets.

While their market share has remained steady at 99 percent, the industry has grown considerably as regulatory changes have consistently increased the need for ratings issued by firms with the NRSRO designation. It is almost impossible for a rating firm to compete in this industry without the designation. I believe it is important for us to consider the manner in which the designation is awarded.

The single most important factor in the SEC staff's NRSRO process is the national recognition requirement. As many commentators have noted, this presents an obvious dilemma for firms seeking to do business in this industry. To receive the license, a firm must be nationally recognized, but it cannot become nationally recognized without first having the license.

There are other key questions with respect to the NRSRO regime. For example, what is the SEC staff's definition of the term "NRSRO"? There are no objective standards. What constitutes the application process? What is the time frame involved for a decision?

Once a firm is approved, is there any way for the investors to know an NRSRO continues to meet the requirements necessary for the designation? What amount of ongoing oversight by the SEC occurs? There is no transparency, I believe, in the process.

The Commission has studied ways to improve and to clarify the NRSRO system for more than a decade, but has failed to act in spite of two concept releases. Two proposed rules—a comprehensive report mandated by the Sarbanes-Oxley Act, 2 days of public hearings, and an investigation of the NRSRO's triggered by the Enron scandal that revealed numerous problems at the then-three NRSRO's, including potential illegal activity.

Considering the artificial barriers erected by the NRSRO system, it is not surprising that the rating system is highly concentrated. It is even more concentrated than the accounting profession, which is controlled by four firms. Here, only two companies dominate the business. The Big Two—Standard & Poor's and Moody's—generate unusual high operating profits for their publicly traded parent corporations. The profit margins are among the highest in the corporate world.

Some describe the market penetration of these companies as remarkable, even astonishing. Both S&P and Moody's rate more than 99 percent of the debt obligations and preferred stock issues publicly traded in the United States. Given their profit margins and market penetration, it is understandable why the Big Two have been called a shared monopoly, a partner monopoly, and a duopoly. Their 99-percent market share suggests that they do not actually compete with each other, particularly in the corporate bond market.

These conditions raise questions regarding the impact of the NRSRO system on investors and the markets. Has the absence of competition affected the quality of ratings, as some have suggested? Were NRSRO failures to downgrade Enron, WorldCom, and others in a timely manner a result of the current system's fundamental weaknesses?

The existing regime also raises critical questions regarding the treatment of conflicts of interest. In addition to the inherent conflict of debt issuers paying rating agencies for ratings, there have been suggestions that the NRSRO's are marketing ancillary, fee-based consulting services to their issuer clients. This practice, if true, raises questions about the independence and objectivity of the rating agencies.

Of course, it is difficult to assess some of these criticisms of NRSRO's because they are so lightly regulated and they conduct a great deal of their activities with minimal scrutiny.

For example, information with respect to rating fees is limited. We do not know whether and to what extent NRSRO's are marketing additional services, such as consulting, to their issuer clients or engaging in anticompetitive practices, such as notching.

We do not know whether the firms are complying with their procedures and ethics codes. We do not know any of these things because the SEC does not conduct periodic inspections of the NRSRO's.

Three decades after granting a few firms privileged status with protection from competition, senior SEC staff recently questioned

whether the Commission even has the statutory authority to oversee NRSRO's. It is quite clear that the U.S. Congress has a decision to make regarding this essentially self-regulated yet noncompetitive industry with duopoly profits.

This morning, the Committee welcomes the distinguished panel of witnesses. From left to right, we will hear from Mr. Paul Schott Stevens, President, Investment Company Institute; Mr. Glenn Reynolds, Chief Executive Officer, CreditSights, Inc.; Ms. Vickie Tillman, Executive Vice President for Credit Market Services, Standard & Poor's; Mr. Frank Partnoy, Professor of Law, University of San Diego School of Law; Ms. Colleen Cunningham, President and Chief Executive Officer, Financial Executives International; Mr. Damon Silvers, Associate General Counsel, AFL–CIO; Mr. Jeffrey Diermeier, President and Chief Executive Officer, CFA Institute; and Mr. Alex Pollock, Resident Fellow, American Enterprise Institute. We welcome all of you to the Committee.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, thank you very much for holding this hearing on assessing the current oversight and operations of the credit rating agencies. Credit rating agencies play a very important role in the capital markets by providing opinions to investors on the ability and the willingness of issuers to make timely payments on debt instruments. These ratings issued by the agencies can have very significant impacts. *The Washington Post,* in an article in November 2004, wrote, "They can, with the stroke of a pen, effectively add or subtract millions from a company's bottom line, rattle a city budget, shock the stock and bond markets, and reroute international investment."

Investors rely upon the agencies' impartiality, and they rely upon their ratings. The SEC created the designation of nationally recognized statistical rating organization, NRSRO, which is currently applies to five agencies, and many institutional investors buy debt only if it has been rated by an NRSRO.

A *Reuters* article last month, February 2006, stated, "The SEC designation gives these firms a major advantage in competing for business against other firms."

In recent years, concerns have been raised about the industry. In late 2001, the largest credit rating agencies maintained an investment grade rating on Enron debt after its major financial restatements and until 4 days before Enron declared bankruptcy. As a result, as *BusinessWeek* reported, there was a barrage of criticism that raters should have uncovered the problem sooner at Enron, WorldCom, and other corporate disasters.

Today's hearing will provide us with the opportunity to hear testimony on issues that have been raised about the credit rating industry, issues such as: Competition in the credit rating industry and barriers to entry; the regulatory process for recognizing NRSRO's; the SEC's legislative authority to regulate, exam, or impose requirements on rating agencies; conflicts of interest that may arise under several circumstances, such as when rating agencies are paid by the issuers they rate; sell consulting services or have affiliates that sell services or products to issuers which they rate;

or have a director who also holds an executive position for an issuer that is rated—alleged anticompetitive processes such as those former SEC Chairman Bill Donaldson identified, "tying arrangements, solicitation of payments for unsolicited ratings, and threats to modify ratings based on payment for related services."

The testimony today will add to the Committee's record from the hearings in February of last year when witnesses representing rating agencies, the bond market, and financial professionals testified on the role of credit rating agencies in the capital markets, and in March of last year when then-SEC Chairman Bill Donaldson testified on the Commission's rule proposal to define the term "NRSRO," and on staff discussion with the NRSRO's about a possible voluntary oversight framework.

Mr. Chairman, I commend your ongoing interest in this area. I look forward to working with you on addressing the many issues involved. I join you in welcoming the distinguished panel of witnesses, and I look forward to hearing their testimony.

Chairman SHELBY. Thank you, Senator Sarbanes.

Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I, too, appreciate very much your attention to this issue and look forward to our witnesses' testimony this morning.

Chairman SHELBY. Thank you.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

I want to welcome our witnesses. I used to be a Governor, and I used to meet with rating agencies on a fairly regular basis. Before that, I was State Treasurer and a bond issuing officer, so I have a special appreciation for the work that you do and just a great appreciation. One of the happiest days of my life as 8 years as Governor was the 3 days that we got upgrades to AAA from Moody's, S&P, and Fitch. I will always remember those days. And whenever I am having a bad day, I just get out those press clips and read them all over again.

[Laughter.]

I am going to be in and out today. I look forward to your testimony. We are just delighted that you are here. This is an important hearing. Thank you for being with us.

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman. I think you covered most of the critical points in your opening statement. I do not have any formal remarks, but I do think this is an area that deserves our attention. My concern and I think my caution is that we make sure whatever solution we proposes, it addresses the problem. And I do not see the problem as being one of a lack of regulation or need for additional regulation in the area of particular business practices as much as it is a question of a lack of competition. And I think that competition is lacking in part because there are a

number of barriers to entry, and one of the most significant barriers to entry are regulations, and they are the barriers that have been created by—unintended, but have been created by some of the existing regulations, and we need to look carefully at those.

We have sophisticated financial markets. We want to make sure we have good disclosure, good standards for certification, but at the same time, if you look just at the market share data, which I think the Chairman quoted in his opening testimony, you see one of the most concentrated markets in the entire country, one of the most concentrated market share profiles in the entire country, and it is an industry that currently acts as an oligopoly, and that can create a lot of bad behavior and a lot of pricing problems. And that is not necessarily the case or the fault of the participants. Again, we get back to the question of whether we have a regulatory structure that is actually discouraging competition. No one wants that to happen, but it could well be the effect of some of the existing rules.

So this is a critical issue. We have the ability to make, I think, modest changes that will result in greater competition, greater pricing, greater range of choices for both investors and companies that seek to get rated by one of these important firms.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I look forward to the witnesses' testimony, and I hope that we will hear part of the concerns that many of us have expressed about the timeliness of the essence of the ratings and the nature of, particularly at State and local governments, timely basis of financial troubles that may exist. And while I have been on the other side of this equation, as Senator Carper has, in receiving ratings, as a former mayor and being in the State legislature as well, I am increasingly concerned about finding out too late in the process and what that means both for the public when it is a public entity and what it means for employees when it is a private entity.

So, I look forward to the testimony.

Chairman SHELBY. Thank you, Senator.

All of your written testimony will be made part of the hearing record, if you will—it is a large panel—briefly sum up your remarks.

Mr. Stevens, we will start with you.

STATEMENT OF PAUL SCHOTT STEVENS
PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you, Mr. Chairman. Good morning.

As you have noted, I am President of the Investment Company Institute, the national association of U.S. investment companies. Our members include mutual funds, closed-end funds, exchange-traded funds, and sponsors of unit investment trusts. ICI members manage a total of approximately $9.6 trillion.

This is my first opportunity as President of the ICI to testify before the Committee, so ably led by you, Chairman Shelby. Under your leadership and that of Ranking Member Sarbanes, the Committee has been very active on critically important issues affecting

all aspects of our capital markets. I do commend you for holding this hearing to examine the current oversight and operation of credit rating agencies. The institute welcomes the opportunity to provide its views on these issues and others before the Committee.

Credit rating agencies play a significant role in the U.S. securities markets generally and vis-á-vis mutual funds in particular. Mutual funds employ credit ratings in a variety of ways: To help make investment decisions, to define investment strategies, to communicate with their shareholders about credit risk, and to inform the process for valuing securities.

The most significant influence of credit ratings on the fund industry is on the $2 trillion invested in money market mutual funds. Money market funds are a remarkable chapter in U.S. financial history. For many years, retail and institutional investors alike have relied on money market funds as an indispensable tool for cash management because of the high degree of liquidity, stability in principal value, and current yield that they offer. ICI estimates that between 1980 and 2004, roughly $100 trillion flowed into, and the same amount out of, money market funds.

If money market funds are an industry success story, they also most certainly are an SEC success story. Since 1983, money market funds have been governed very effectively by Rule 2a–7 under the Investment Company Act of 1940.

Rule 2a–7 limits the types of securities in which money market funds can invest in order to help them achieve the objective of maintaining a stable net asset value of $1 per share. Credit ratings form an integral part of these limitations.

Chairman SHELBY. Explain further what you mean there, their limit on what you can invest.

Mr. STEVENS. Money market funds may invest only in securities that are rated by an NRSRO in one of its two highest short-term rating categories, or if the securities are unrated, they have to be determined by the fund's board to be of a comparable quality. So it is a restriction on the way that we can invest our assets. It is written into the regulations, yes, Mr. Chairman.

Now, it is important to note that no governmental entity ensures money market funds. Nevertheless, despite this estimated $200 trillion flowing into and out of these funds over the past 25 years, through some of the most volatile markets in our history, only once has such a fund failed to repay the full principal amount of its shareholders' investments. In that case, a very small institutional money fund "broke the buck"—the $1 per share value—due to extensive derivatives-related holdings.

Now, we believe the record of success achieved under Rule 2a–7 must continue for the benefit of money market fund investors. And this, in turn, depends on the ratings issued by NRSRO's providing credible indications of the risk characteristics of those instruments in which money market funds invest.

To promote the integrity and quality of the credit ratings process and, in turn, serve the interests of investors who utilize credit ratings, we believe it is timely and appropriate for Congress to consider legislation to advance several objectives.

First, the NRSRO designation process should be reformed to facilitate the recognition of more rating agencies and thereby intro-

duce much needed competition in the credit rating industry. The mutual fund sector is one in which intense competition has brought unparalleled benefits to investors. I firmly believe that robust competition can do the same for the credit ratings industry and is the best way to promote the continued integrity and reliability of credit ratings.

Unfortunately, the current SEC process for designation credit rating agencies does not promote but, in fact, retards competition. That process involving the issuance of no-action letters utilizing a vague "national recognition standard" has not worked effectively. In place of the process, the institute recommends the implementation of a mandatory, expedited NRSRO registration process with the Commission.

Second, there should be appropriate regulatory oversight by the SEC over NRSRO's to ensure the credibility and reliability of their ratings. We believe this can be achieved through a combination of: One, periodic filings with the SEC; and, two, appropriate inspection authority for the SEC, coupled with adequate enforcement powers.

Specifically, credit rating agencies should be required to provide key information to the SEC upon registration, including information relating to conflicts of interest, the procedures used in determining ratings, ratings performance measurement statistics, and procedures to prevent the misuse of nonpublic information. NRSRO's should be required to the report to the SEC on an annual basis that no material changes have occurred in these areas. Similarly, they should be required to report any material changes that do occur on a timely basis, and this information should be made available promptly to investors who rely on their ratings. Such disclosures should be accompanied by an appropriate SEC inspection process, tailored to the nature of credit rating agencies' specific business activities.

Third, investors should have regular and timely access to information about NRSRO's to provide them a continuing opportunity to evaluate the ratings that they produce. It is important to our members as investors that they have access to information about an NRSRO's policies, procedures, and other practices relating to credit rating decisions. In particular, it would be helpful for credit rating agencies to disclose to their investors their policies and procedures addressing conflicts of interest, as well as the conflicts themselves, and periodically to disclose information sufficient for investors to evaluate whether they have the necessary staffing, resources, structure, internal procedures, and issuer contacts to serve as NRSRO's.

Finally, they should have some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations. Any reforms to the credit rating process should, at a minimum, make the agencies accountable for ratings issued in contravention of their own disclosed procedures and standards. Surely, the First Amendment does not prevent Congress from requiring credit rating agencies to make truthful disclosures to the SEC and to the investing public. Increased competition, appropriate SEC oversight, greater transparency, and heightened accountability—these are the right objectives for reform of the credit rating industry from the perspective

of mutual funds, other investment companies, other investors, and the securities markets as a whole.

I very much appreciate the opportunity to share the institute's views with you today. I look forward to working with the Committee on these and other issues and would be delighted to take your questions.

Chairman SHELBY. Thank you.

Mr. Reynolds.

STATEMENT OF GLENN L. REYNOLDS CHIEF EXECUTIVE OFFICER, CREDITSIGHTS, INC.

Mr. REYNOLDS. Thank you, Mr. Chairman and Members of the Committee. I am happy to have this opportunity to express our views on this very important subject.

I would just like to clarify that we are an independent research firm. We have never applied to be an NRSRO and have no plans to in the immediate future.

What we would like to say up front is that the timing could not be better for productive change in the credit ratings industry, especially given the trends in the global markets, how information and research is delivered, and who will be delivering it in coming years.

The incumbent NRSRO's will look to represent this current process as being about burdensome regulation and oversight. It is really about lowering barriers and removing structural impediments to competition. The agencies will wave the flag of letting the markets work when, in fact, they are promoting the exact opposite.

Lowering barriers will still mean raising the bar for product quality and innovation, and that point often gets lost in all the angling in the reform process.

New market entrants will need to deliver high-quality products to generate a meaningful revenue stream. The market will get very competitive among the new entrants looking to establish a foothold, and that is not a bad thing at all for quality.

It will take more time for Moody's and S&P to feel any meaningful competitive pressure, but we need to start somewhere. Moody's and S&P have done a good job pushing back the start date of all of this, but the inevitable is on the way.

In our discussions on this topic, we always remind people that business reality, the need to develop quality products, build brand power, and develop distribution capabilities all entails a lot of costs and takes literally many millions of dollars even for small firms.

Individuals do not invest in or work at firms where the product cannot generate cash to grow. Analysts cost money, websites cost money, and opening offices costs money. As Moody's and S&P probably can attest, lawyers and lobbyists most likely also cost a lot of money.

The business reality has always been a very compelling gatekeeper, and always will be. That will be the case with market entrants into the credit ratings industry.

Innovation in the credit markets has always been heavily due to growing competition in the banking and brokerage industry. There were predictions of doom by the securities industry well over a decade ago when the commercial banks started their concerted moves into the traditional underwriting businesses.

The investment banks were playing an old but transparent game of hyping the fear of the unknown. The incumbent securities firms were looking to stave off competition and thought predictions of chaos and trouble might strike a nerve.

The opposite effect came true. Now investors and issuers have much more choice of who they want to deal with, pricing is more competitive, the markets are more efficient, and despite some bumps, the system is stronger and better capitalized.

Innovation in such areas as securitization and risk management have served the U.S. corporate sector well. It is in no small part due to the evolution of the banking and underwriting industry from a small group of a half-dozen bulge bracket investment banks to a global bulge bracket of a few dozen major integrated financial services operations.

The evolution of the credit markets was about letting competitors compete and seeing the market benefit from innovation and choice.

Along the way, Moody's and S&P have been able to hitch a ride to the sweeping benefits that came with this intensified competition. Unfortunately for the market, new ratings firms were essentially blocked by a regulatory system that kept market entrants out, while banking sector innovation fed the rating agencies a steady diet of new business.

All in all, it was a very sweet deal. Wall Street, the investment banks, and the securities firms invent it and engage in brutal competition to market it. Then Moody's and S&P come in and rate it and reap the benefits of inelastic pricing and no choice.

Now Moody's and S&P wave the same red flags around market disruptions. Their take is that hidden risks lurk around the corner that will create problems in the markets. It sounds a lot like what the investment banks were crying about with the commercial banks and non-U.S. banks came into their space. It is an old ploy.

In the case of the banks and brokerage houses, the system in the end benefited, and innovation was everywhere. Not coincidentally, Moody's and S&P cashed in on the value of someone else's competitive excellence.

There is a reason that Moody's pretax profit margins significantly outdistance those of Microsoft and dwarf Exxon Mobil.

That is all well and good. Now it is time to let more high-quality institutions in to compete and push the incumbents to do a better job rather than reap profits tied in part to the market being a price taker by regulatory dictate.

Competition makes an analyst want to know it better than the next guy, write it up faster than the next guy, and look to establish himself and his firm in the market. Quality only benefits from that. Plus if you want to take on these behemoths, you better have a good product, if not some major backing.

We are all in favor of profit maximization, but we also favor fair play and truly competitive markets.

New competition will not be disruptive or undermine quality. That is a ruse. The rating agencies' performance during the scandal years with their Reg FD exemptions and absolute market power does not leave room for them to hype quality fears. After all, we have already seen the downside of quality problems that come with no competition.

We address some of the quality worries we have heard in our formally filed testimony, but do not buy the lie that quality will suffer and information flows will not improve.

In the end, Moody's and S&P may just have to settle for enormously profitable, high-margin growth under the rules of fair competition and open markets that the rest of the underwriting chain has to adhere to. They will somehow bear up under the strain. In the meantime, issuers will have choices as will investors.

Thank you for your time and this opportunity.

Senator SUNUNU. [Presiding.] Thank you, Mr. Reynolds.

Ms. Tillman.

STATEMENT OF VICKIE A. TILLMAN EXECUTIVE VICE PRESIDENT, CREDIT MARKET SERVICES, STANDARD & POOR'S

Ms. TILLMAN. Mr. Chairman, Members of the Committee, good morning. I am Vickie Tillman. I am the head of ratings at Standard & Poor's, and I have been in the business for about 30 years. Let me start by saying that S&P strongly supports the lowering of barriers to entry in our industry and the resulting designation of additional NRSRO's. Over the years, Congress and other regulators have used their NRSRO recognition as a means to provide a quality check for investors. By way of example, the Federal Deposit Insurance Act includes a provision that generally prohibits savings and loans associations from holding securities unless they are deemed investment grade by an NRSRO.

To abandon the NRSRO system would be to abandon this quality check. The result would be a regulatory vacuum that could expose to unwarranted risk the very investors Congress and these regulators have determined to protect.

In our view and in the view of the market, as reflected in an SEC study, a more effective and significantly less disruptive approach is to improve on the existing system. The groundwork for this approach is already in place. The SEC has drafted, published, and received extensive comments on a proposed rule that should lead to a streamlined NRSRO designation process, and more NRSRO's, all of which would promoted competition.

Unfortunately, despite receiving broad support for the proposed rule, the SEC has taken no step, since the close of comments last June, toward finalizing it. We urge Congress to press the SEC to move forward on the proposed rule. The financial markets have accepted the longstanding global practice of S&P and other rating agencies of charging fees to rated issuers.

Despite this broad acceptance, concerns have been raised about potential conflicts of interest arising from this practice. These concerns are unfounded. There is no evidence that the "issuer pays" model compromises the independence and objectivity of ratings. Quite the contrary. Studies have found that any potential conflicts of interest have either not materialized or have been effectively managed. On the other hand, "issuer pays" models have benefits not available under other models. For example, it allows rating agencies to make their ratings available to the entire market without cost. S&P does this by, among other things, posting our rating actions on our free website. In this way our ratings are subject to

constant market scrutiny. The "issuer pays" approach also allows for the ongoing monitoring of ratings and the rated issuers.

Put simply, effective ways exist to increase competition and manage potential conflicts of interest in our industry without drastically overhauling a system that has worked for decades. We believe that legislation, therefore, is unnecessary at this time. It could also be harmful to the quality of ratings. Ratings are opinions, and analysts must be free to form their opinions without fears of being second guessed or subjected to sanctions for ratings others might feel are too high or too low. Substantive SEC oversight or legislation of the analytical process would necessarily involve such second guessing, and we believe, cause analysts to be unduly tentative or conservative in their analysis so as to avoid later criticism.

In our view, a better approach is one that was recently adopted by the European Commission following an intensive stud of the issues. The EC determined that oversight of rating agencies is more appropriately accomplished through the establishment of codes of conduct, such as the S&P code of conduct that I have attached to my testimony.

To that end, we have been working diligently with the SEC and the other NRSRO's toward the adoption of an oversight framework. Each NRSRO would adopt, as S&P already has, a code of conduct, and would establish an independent internal audit mechanism by which to test annually compliance with that code. The audit results would be shared and discussed with members of the SEC staff. We have met with the SEC on many occasions, and are now close to final agreement on the framework. Not only would such an approach avoid the public policy pitfalls of more intrusive Government oversight, but it would also avoid infringing the well-established First Amendment rights of S&P and other rating agencies.

Thank you, I would be happy to answer any of your questions.

Chairman SHELBY. Thank you.

Professor Partnoy.

STATEMENT OF FRANK PARTNOY, PROFESSOR OF LAW, UNIVERSITY OF SAN DIEGO SCHOOL OF LAW

Mr. PARTNOY. Thank you, Chairman Shelby, Ranking Members Sarbanes, and Members of this Committee, for the opportunity to testify today. I am a Law Professor at the University of San Diego, where I have spent much of the past 9 years studying the credit ratings industry.

First, a bit of historical perspective. When I wrote my first academic article on credit rating agencies, Moody's was not a public company, and S&P was a relatively small line item at McGraw-Hill. I argued that the companies had an unfair oligopoly because of legal rules that required the use of NRSRO ratings. I also set forth evidence showing that ratings often are "too little, too late," because they generate little information and lag the market by months.

I did not expect much of a response—academic articles rarely receive much of a response. But the NRSRO's sent representatives to meet with me in San Diego and to discuss my findings at an academic conference. They also began a lobbying effort aimed at influ-

encing opinion in the area. Moody's funded an academic research and advisory committee, and even hired academics who had been examining NRSRO's.

Not much changed until Enron collapsed in late 2001. As evidence emerged that the NRSRO's had played an important role, the U.S. Senate decided to examine the NRSRO process. When Senator Joseph Lieberman's staff invited me to testify before the Senate Committee on Governmental Affairs in January 2002, more than 4 years ago, Senators from both parties asked detailed questions about the serious problems and dangers in the credit rating industry.

Shortly thereafter, Moody's went public, with shares worth just about $4 billion, about one-seventh of the value of General Motors, and less than half the value of major financial firms such as Bear Stearns. Congress ultimately included, as part of the Sarbanes-Oxley legislation, a provision requiring that the SEC reexamine the NRSRO designation, and I thank the Members of this body, particularly Ranking Member Sarbanes, for doing so.

Today, we have the results of that investigation and the evidence against credit rating agencies is damning. The problems I addressed in 1999 have multiplied exponentially. Moody's and S&P are more powerful and profitable than ever, and the dangers associated with the NRSRO system are much greater than they were in 2002. Moody's shares are now worth $20 billion more than those of either General Motors or Bear Stearns. Moody's shares have increased in value by more than 500 percent since they were issued, when the rest of the market was down.

Moody's and S&P say they are merely publishing companies, and that they distribute their ratings to the public for free. But if that is right, why have they become so much more profitable?

Even a simple financial analysis shows that the NRSRO's are not in the publishing business. For example, Moody's shares are worth more than the combined value of Dow Jones, publisher of *The Wall Street Journal*, *The New York Times*, *The Washington Post* and Knight-Ridder, which owns dozens of publications. But Moody's has only a fraction of those firms' employees, and provides far less information.

And credit ratings certainly are not free. The cost of ratings are passed to investors who buy rated securities, which are more expensive than they otherwise would be, by billions of dollars, because issuers are effectively required to pay for ratings.

The NRSRO's increasing oligopoly profits are a dangerous sign, a symptom of an infection spreading through the financial markets. Because regulators make NRSRO ratings so important, investors have incentives to engage in dysfunctional behavior to try to obtain high ratings, and they pay very high fees to do so. The rating agencies are conflicted, not only because issuers pay for ratings, but they also provide consulting services and threaten unsolicited ratings. The multitrillion dollar credit derivatives industry, which is driven by NRSRO ratings, and generates a large share of NRSRO profits, is opaque, volatile, and downright frightening.

Overall, the NRSRO regime poses a serious threat to the financial system. It is no coincidence that NRSRO ratings played a cen-

tral role in the bankruptcy of Orange County, the collapse of Enron, and numerous other scandals.

In my view, the ideal solution would be to replace the entire NRSRO regime with one based on market measures. Every day, every hour, even every second, the markets provide information about the risks of particular securities. Indeed, the NRSRO's use these very measures, albeit not very well, in determining ratings. Congress might simply replace NRSRO ratings with reasonable market ranges.

Alternatively, I believe, H.R. 2990 is a fair compromise. It would increase competition and create incentives for rating companies to use market-based measures and/or receive fees from investors rather than issuers, and pressure from competition will vastly improve quality in the credit rating industry. To the extent there are market-based constraints, they should eliminate any "race to the bottom." I have not see evidence that opening markets to competition would be disruptive or lead to rate shopping. Instead, it is the conflicts of interest and perverse incentives associated with the current NRSRO system that pose the greatest concerns. Indeed, it is possible that S&P and Moody's will continue to dominate the industry after reform, but if they do so, it will be because of high-quality ratings and not because of a regulatory oligopoly.

Let me conclude just very briefly by mentioning three issues related to NRSRO accountability, which I believe should be part of the discussion. First, Federal law currently exempts NRSRO's for Federal securities fraud. It should not.

Second, Moody's and S&P have claimed that their ratings are merely opinions that are protected as free speech. In my opinion, that argument is laughable. H.R. 2990 is not unconstitutional. If it were, much of the Federal securities law system would be subject to challenges based on the First Amendment.

And third, the NRSRO's have argued they can take care of any industry problems on a voluntary basis, perhaps with the help of the SEC, but both the NRSRO's and the SEC have demonstrated during the past three decades that they cannot be trusted to reform the credit rating business.

Our financial markets are the strongest in the world, in large part because Congress has intervened at critical moments to reshape the financial landscape. When the stock market collapsed in 1929, Congress responded with important legislation, not just once, but several times over a period of years. In 2002, Congress offered its first response to the wave of corporate scandals with the Sarbanes-Oxley legislation. In my view, now is the time for Congress to continue that response by acting on this crucially important issue of credit ratings.

Thank you again for the opportunity to give you my thoughts.

Chairman SHELBY. Thank you.

Ms. Cunningham.

STATEMENT OF COLLEEN S. CUNNINGHAM PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL EXECUTIVES INTERNATIONAL

Ms. CUNNINGHAM. Thank you, Chairman Shelby, and Members of the Committee, for this opportunity to appear before you today.

I am the President and Chief Executive Officer of Financial Executives International. FEI is a leading advocate for the views of senior financial executives representing 15,000 CFO's, treasurers, controllers in the United States and Canada.

I am pleased to have the opportunity to share our views with you today on the important issue of credit agency operations and oversight.

There are more than 100 CRA's operation worldwide, but only five are designated as nationally recognized statistical rating organizations by the Securities and Exchange Commission. These five enjoy a competitive advantage over their peers because the guidelines for many government, mutual fund, and other institutional investment portfolios not only specify minimum credit ratings for their securities, but also require that the ratings come from NRSRO's. The absence of competition and the ambiguity surrounding the designation criteria have left these incumbent NRSRO's with a distinct competitive advantage.

The most effective way to increase competition in the credit agency market would be to eliminate the no-action process the SEC uses to recognize NRSRO's, and to replace it with transparent registration requirements, which any CRA can understand and aim for.

Additionally, there is no mechanism in place in the current system to ensure that NRSRO's continue to satisfy the criteria necessary to maintain their designation. Once a rating agency has been designated, it is only required to notify the SEC when it experiences material changes that may affect its ability to meet these criteria. Given the enormous financial impact that a loss of designation would have on a rating agency, I believe it is unrealistic to expect them to police themselves. For this reason, I urge Congress to increase accountability through regular performance audits to ensure that registered CRA's continue to satisfy this criteria.

I also believe the CRA's should be required to disclose additional information about their operations as part of their registration application with the SEC. These disclosures could address such items as the CRA's policies and procedures for protecting nonpublic information, and for handling conflicts of interest. The training and experience of those individuals tasked with developing the ratings, and the extent to which the CRA staff met with an issuer's management prior to developing its rating. This information would help investors differentiate between or among registered CRA's and might help issuers decide which rating agency to retain for rating purposes.

Yet another flaw in the current system is that it fails to address the important issue of conflicts of interest. For example, some have sold fee-based advisory services to their rated-A clients in areas such as risk management, corporate governance, shareholder disputes, and data analysis. The NRSRO's offering these services have assured policymakers that they have erected adequate firewalls between their rating service and advisory service operation. While this may be true, issuers may, nevertheless, feel pressure to purchase advisory services to enhance the likelihood of receiving a good rating.

I believe that a simple rule, similar to the restrictions included in Title II of the Sarbanes-Oxley legislation, as the Members of this Committee know well, would solve this problem. Title II of the Sarbanes-Oxley Act addressed the issue of auditor independence, and listed specific activities which registered audit firms could no longer perform for their audit clients. I believe a similar line should be drawn here. Rating agencies should not be permitted to provide both fee-based advisory services and rating services to the same issuer. This bifurcation of rating services and advisory services would help ensure that credit ratings are developed based solely on the company's creditworthiness, and not on any unrelated matters.

In closing, I would like to urge Congress to introduce legislation that addresses the three concerns I have raised, the need to increase competition in the marketplace, the need to increase accountability and credit agency operations, and the need to eliminate conflicts of interest.

That concludes my remarks. I want to thank the Chairman and the Members of the Committee for inviting FEI to participate in today's hearings, and I would be pleased to answer any questions.

Chairman SHELBY. Thank you.

Mr. Silvers.

STATEMENT OF DAMON A. SILVERS ASSOCIATE GENERAL COUNSEL, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. SILVERS. Thank you, Chairman Shelby and Member. I appreciate Senator Sarbanes' leadership in this as well.

The AFL–CIO appreciates the opportunity to discuss the credit rating agencies and the role they play in the debt markets from the perspective of America's working families, who look to the credit markets to finance their employers, support their communities, and to fund their retirement and their children's education.

Union-sponsored benefit funds have over $400 billion in assets, and union members participate in benefit funds with over $5 trillion in assets. Most defined benefit funds have between 40 and 60 percent of their assets invested in fixed-income investments. Our funds rely on credit rating agencies to help price these assets, and when the agencies get it wrong, as they did in Enron, our funds paid the price. The AFL–CIO called, in 2001, 1 week after the bankruptcy of Enron, for the SEC and Congress to address conflicts of interest and quality issues at the rating agencies, and we are very pleased to see, Mr. Chairman, you are taking up that task at this time, as you have for some time.

Credit rating agencies are a vital part of the functioning of our capital markets. As one Moody's spokesperson has said, "Our ratings are essentially a public good." The public good here is the provision of reliable, easily analyzed credit quality data to all credit market investors that enable investors to quickly and efficiently make investment decisions without each investor having to determine for themselves the degree of risk involved in a given financial instrument.

However, this system is vulnerable to structural problems in particular, because the credit rating business is an effective duopoly, as the Chairman noted, with the Congressional Research Service estimating that Moody's and S&P together have 80 percent of the market.

Many have expressed concern about the level of concentration and the business of auditing public companies. Obviously, the degree of concentration in the credit rating business is substantially greater, with two dominant firms and one subordinate firm, compared to four comparably sized major public audit firms and a substantial number of minor ones.

While there are benefits to having a limited number of well-regarded credit rating firms, information, economics benefits to investors and other market participants, the current degree of concentration appears to us to be excessive. However, greater competition by itself is unlikely to be a sufficient solution to the structural problems with the credit rating business. There are two reasons for this.

First, the scale and prominence of the existing firms are going to be a formidable barrier to entry, regardless of the regulatory changes that have been discussed here this morning.

Second, and I believe more critically, there is a structural principal agent problem here that is unlikely to go away because the real customers are not doing the buying. It is hard to see how the real customers, the investors, and other people making investment credit quality decisions, are going to be able to do the buying without substantially detracting from the liquidity of the credit markets and the general availability of information.

In this respect, as in many others, the credit rating business has similarities to the business of public company auditing, and for this reason, this business is not—there are risks in this business in looking to competition to be the sole solution because there is an interest on the part of both the rating agencies and the purchasers of their services to collude, and in particular to collude in areas, such as a previous witness mentioned, where the public interest is very much at stake, like in the area of what securities, S&L's, and other regulated entities buy.

We have seen in both the *Washington Post* coverage of the rating agencies and in the SEC's examination of the same allegations, evidence of exactly the abuse one would expect to see in an unregulated monopoly providing a public good: Alleged differential treatment of firms, depending on whether they paid rating agency fees, agencies engaging in consulting businesses that parallel their core rating businesses, and extracting essentially concessions from the companies they rate, and lax treatment of major issuers like Enron with devastating consequences.

We believe that there must be, as a result, public oversight of the rating agencies. I think you will find that my views on this parallel those of the FEI, and of the ICI, which is a new experience for me in certain instances.

[Laughter.]

This oversight must focus on three areas: Monitoring the seriousness of agency reviews of issuers, preventing abuse of business practices like coercing payments through bad ratings, and putting

an end to conflicts of interest that lead rating agencies to become too cozy with the companies they rate. Again, this is analogous to the bar and most auditor-consulting services contained within the Sarbanes-Oxley Act and expanded on by the PCAOB.

We find the need for regulation particularly compelling in light of the—extensively discussed here today—existence of the NRSRO concept in our securities laws. The NRSRO concept though is helpful in dealing with information cost to investors, Government agencies, and a wide variety of financial market actors. Replacing it with a mere registration process without substantive oversight, in light of the principal agent problem I discussed a moment ago, as some have suggested and is embodied in legislation introduced in the House, will be harmful to investors and ultimately to the functioning of our credit markets.

However, the NRSRO system today should be more transparent and open so that firms that wish to become NRSRO's know what that entails, and so that existing NRSRO's can be held accountable to clear standards. Obviously, it also should be possible for firms that are not NRSRO's to become one, and that the process ought not to be Catch–22.

For these reasons, we would favor the regulation of the rating agencies either by the SEC directly or by a PCAOB-like body with the powers to set specific criteria for being recognized as an NRSRO, powers to oversee agency practices, set positive standards, and prescribe abusive practices. This direction was embodied in the recommendations of the Senate Governmental Affairs Committee's October 2002 report following the collapse of Enron, and was raised and addressed extensively by the SEC in its June 2003 concept release, but as has been noted by prior witnesses, the Commission has not taken final action on any of these items, even the rather modest reforms in the NRSRO application process from the June rulemaking.

This Committee can be very proud of its work in crafting the Sarbanes-Oxley Act of 2002. That Act contains within the principles that should be applied to the credit rating agencies, real independent oversight and an end to conflicts of interest. Credit rating agency regulation is part of the unfinished agenda of corporate reform, like the reform of executive compensation that the SEC is now attempting, and the continuing need to reform public company board elections that remains today unaddressed.

The AFL–CIO commends this Committee for taking up this issue, and hopes that this unfinished agenda item can be finished. We appreciate very much the opportunity to appear before the Committee.

Mr. Chairman, we appreciate your leadership in this area, and we look forward to working with you as you move forward.

Chairman SHELBY. Thank you.

Mr. Diermeier.

STATEMENT OF JEFFREY J. DIERMEIER
PRESIDENT AND CHIEF EXECUTIVE OFFICER, CFA INSTITUTE

Mr. DIERMEIER. Good morning. I am Jeff Diermeier, and I am President and Chief Executive Officer of CFA Institute. Up until about 14 months ago, I was a 29-year veteran of the institutional

investment management wars, most recently as Global Chief Investment Officer of UBS Global Asset Management.

I would certainly like to thank Senator Shelby, Senator Sarbanes, and other Members of the Committee for the opportunity to speak to you this morning on this important topic.

First, some background about CFA Institute. CFA Institute is a nonprofit membership organization made up of individuals, investment professionals with a lofty mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. We also fund and support the CFA Center for Financial Markets Integrity, which promotes high standards of ethics and integrity.

A common denominator for anyone involved with our organization is adherence to a code of ethics that I am comfortable calling the highest ethical standard that exists for investment professionals. CFA Institute is also a staunch proponent of self-regulation. This approach is embodied not just in our own code of ethics, but also in a number of additional guidelines and standards we have established in areas such as issuer-paid research and objectivity of analyst research.

A necessary prerequisite to self-regulation is that it must be embraced by the market participants whose activities it attempts to standardize. Such appears not to be the case with credit rating agencies that have been reluctant to embrace any type of regulation over the services they provide to the investment community. This, despite the fact, from our viewpoint, that their business model appears to have significant conflicts. In a business that relies upon public trust for its existence, credit rating agencies should be held to the highest standards of transparency, disclosure, and professional conduct. Instead, there are no standards, there is no oversight.

We are pleased to see that the Committee has listed, as a priority for the second session of Congress, the need to address conflict of interest and competition concerns that have been raised about credit rating agencies, as Senator Shelby announced on January 31.

Were credit rating agencies operating within an environment of openness and transparency of business practices, free from substantial conflicts of interest, your Committee might have been advised to leave them alone. Such is not the case. Their problems notwithstanding, if credit rating agencies were willing to engage with regulators to address a variety of serious issues facing their businesses, it would have been reasonable for your Committee to let those discussions run their course. Such is not the case. Or if credit rating agencies were eager to avoid regulation, but began serious dialogue about a self-regulatory system, there would be no need for this Committee to focus its attention on these issues. Such is not the case.

What we hear from rating agencies, when prompted, on the idea of reform does not help matters. They state that theirs is not a product intended for use by investors and that their work should

be protected under the First Amendment as journalist product. These viewpoints, I understand, may perform well in a court of law, but they are not in alignment with the reality that investors do indeed rely on their services as an important tool in verifying the legitimacy of debt securities.

Chief among the issues are conflicts of interest that appear to exist, notably that rating agencies rely on revenues provided from the issuers that they rate. These conflicts are exacerbated by rating agencies pitching ancillary services to issuers, such as prerating assessments and corporate consulting. In these relationships, the rated companies hold the cards, meaning they have the power to end the contract if and when the rating agency offers anything other than glowing review. Rating agencies are under constant pressure to issue favorable reviews in order to retain a particular book of business. Further, agencies are under no obligation whatsoever to publish their findings. Negative reviews, therefore, never make their way to the investing public.

Under ordinary circumstances, competitive market forces might be capable of solving this problem. Those with reputations of full disclosure and investor focus could be expected to rise to the top. But, ironically, the one bit of authority the SEC does have is to require issuers of publicly trade debt securities to receive credit ratings from NRSRO's. This has the unintended consequence of reducing competition, since the threshold for a new entrant in the marketplace to achieve nationally recognized status is practically insurmountable. As a result, only five agencies hold this coveted status. In other words, even though rating agencies are not beholden to regulators, they nonetheless are beneficiaries of the rules that are in place for issuers.

It is our belief that the standoff between rating agencies and the SEC is likely to remain unless Congress decides either to expand the SEC's oversight powers and/or to mandate rating agencies to submit to either involuntary regulation or voluntary self-regulation. Given the impasse that appears to exist between the SEC and rating agencies, we have a number of suggestions that we believe your Committee should consider as it determines how to address the current situation.

First, the NRSRO definition is antiquated and must be revised. The initial hurdle to become nationally recognized is high and has had the unintended consequence of reducing the ability of new entrants into the marketplace, placing an emphasis on recognition versus an emphasis on competence.

Second, regulatory oversight for credit rating agencies should be assigned to the SEC and rating agencies should be subject to periodic SEC review. Without adequate authority assigned to the SEC, any changes that the agencies make, either voluntary or by regulation, cannot be quantified or verified.

Third, I believe the situation we are talking about here with credit rating agencies is materially similar to a situation we have dealt with in the area of issuer-paid research. In this case, small companies that are not covered by Wall Street analysts pay firms to provide equity research. To address these conflicts, the CFA Institute and the National Investor Relations Institute partnered to develop best practice guidelines for managing the relationship be-

tween corporations and financial analysts. I believe these guidelines, entitled “Best Practice Guidelines Governing Analyst-Corporate Issuer Relations,” could serve as a model if and when standards for better managing the relationships between corporations and credit rating agencies are developed. We will provide a copy of the guidelines with my written remarks.

Another relevant situation of the recent past is the well-documented conflict that has existed between the investment banking and research departments at brokerage firms. This, of course, has had a multitude of consequences, most notably that analysts received pressure from both inside and outside their firms to issue favorable recommendations on the stock of current and potential investment banking clients.

In this case, CFA Institute developed research objectivity standards to address the conflicts in the research process which are not limited to equity research, but extend to fixed-income research as well. The same disclosures and restrictions should be required of credit rating agencies.

Fourth, an industry-wide standard of professional conduct should be developed that clearly defines standards of independence, appropriate relations between agencies and issuers, and duties to the investing public. Analysts and supervisors should be required to attest annually of their adherence to the standard. In many cases, simply identifying the areas of conflict and processes to eliminate or manage those conflicts would be a big step forward, but annual attestation of adherence moves us to a higher standard.

This code of conduct should require rating agencies to explain in their written reports what analyses were performed in arriving at a particular rating and what factors were considered in preparing the rating. The current lack of transparency that is endemic among rating agencies must be address. No NRSRO standards currently exist for defining what minimal analysis should be performed.

This code of conduct should also require NRSRO’s to adhere to standards that govern the analysis performed. One of the simplest approaches would be to require that policies and procedures be established and verified to ensure compliance. These could include requiring documentation in support of the analyses, as well as a periodic supervisory view of the documentation and ratings. Last, the code of conduct should establish minimum competency requirements within rating agencies for those who analyze securities and assign their ratings.

As I stated earlier, CFA Institute is a proponent whenever possible for self-regulation over government-mandated regulation. Nonetheless, we recognize that self-regulation has its limitations and there comes a time when a full-fledged regulation may be the only course of action. Of all the directions this Committee has at its disposal, we believe the one direction it absolutely should avoid is the status quo.

The code of ethics I mentioned earlier which all of our 80,000 members must abide by requires them above all else to place the interests of investors first. And we believe that this Committee, the SEC, and rating agencies, if they are to follow that same basic principle, will ultimately find the right solution. CFA Institute is

committed to providing our perspective and any type of assistance we may give the Committee.

Thank you very much.

Senator BENNETT. [Presiding] Thank you.

Mr. Pollock.

STATEMENT OF ALEX J. POLLOCK
RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. POLLOCK. Thank you, Senator, and I would like to thank the Chairman, Ranking Member Sarbanes, and Members of the Committee for the opportunity to be here today. These are my personal views on the need to reform the credit rating agency sector.

I think it is both important and also quite timely for Congress to address this issue now, since the actual result of the SEC's actions, and in recent years its notable inaction, as various other panelists have pointed out, has been to create and sustain a Government-sponsored cartel, or the term you used, Mr. Chairman, a Government-sponsored shared monopoly.

A few weeks ago, *Barron's* magazine had this to say, "Moody's and Standard and Poor's are among the world's great businesses. The firms amount to a duopoly and they have enjoyed huge growth in revenue and profits. Moody's has a lush operating profit margin of 55 percent, S&P of 42 percent." And I have to say if I were a manager of such a firm, I would try very hard to maintain the status quo.

One securities analyst recommending purchase of Moody's shares wrote, "Thanks to the fact that the credit ratings market is heavily regulated by the Federal Government," rating agencies enjoy what he called "a wide economic moat"; in other words, protection. It is my recommendation that Congress should remove this Government-created protection or economic moat and instead promote a truly competitive credit rating agency sector, and that will bring all the advantages of competition to the customers of ratings.

It is my view that the time has come for legislation to achieve this. Instead of allowing the SEC to protect the dominant firms, which it does, in fact, although I do not believe it does so on purpose, it is my view that Congress should mandate an approach in legislation to end the Government-sponsored cartel and credit ratings. As part of this, you obviously have to think about this NRSRO issue, as many others have discussed and you have covered quite well in your opening comments, Mr. Chairman.

I think the nub of the matter is that a competitive market test, not a bureaucratic process, should determine which credit rating agencies end up earning the market's view that they are the worthwhile, recognized agencies, so competition can provide its normal benefits of higher quality and lower costs. I will note this is completely different from the approach taken in proposals by the SEC staff on the NRSRO issue, and these proposals, in my opinion, are unsatisfactory.

On the other hand, I believe that very much in the right direction is the bill which has been mentioned before introduced into the House by Congressman Fitzpatrick, H.R. 2990. What this bill does is directly address a really big, practical problem with the NRSRO issue, which is that this NRSRO designation over the three decades

of its life has become enshrined in a very large and complex web of regulations and statutes which all interlock and interact with each other and pose a serious question of how could you ever untangle this web which affects thousands of financial actors, basically all of the regulated parts of the financial system, which is most of the financial system.

H.R. 2990 does this in what I believe is an elegant fashion by keeping the abbreviation "NRSRO," but completely changing what it means. As you know, it does that by changing the first "R" from "Recognized" to "Registered," so you have nationally registered credit ratings organizations. This change would move us from an anticompetitive designation regime, which is what we have now, to a procompetitive disclosure regime. Many of the other members of the panel have mentioned the need for operating on a disclosure basis.

I believe that registration in such a system should be voluntary, and if any rating agency, such as apparently Mr. Reynolds' firm, does not want to be an NRSRO, it should not have to be. But if it wants to be an NRSRO, the way is plain and clear what you do to get there. If you do not want to be an NRSRO, then your ratings cannot be used for regulatory purposes. And if you are happy with that, we should be happy with you, but if you want entry into this regulated part of the system, then you should have to register as a nationally registered rating agency. This voluntary approach, in my view, entirely removes any First Amendment objections which can be made.

A very important advantage of a voluntary registration system is it would allow multiple pricing models for the credit rating agency business. As has been discussed, the model of the dominant agencies is that securities issuers pay for credit ratings, which arguably creates a conflict of interest which needs to be closely managed.

The alternative is, of course, having investors purchase the credit ratings directly, and this seems to create a superior incentive structure. If the investors pay, it obviously removes any potential conflict. I am not suggesting that regulation should require one or the other, just that both should be available in the market. This contrasts to the SEC staff proposal which would enshrine the issuer-paying model in the regulation.

I do not believe we should have actual regulation of credit ratings by the SEC or the process of forming credit ratings. I think that would be a worse regime that we have now, but we do need a competitive system. I do not think there is any doubt that a fully competitive rating agency market would perform better, but it will not happen all at once. This would be an evolutionary process and the desirable transition, given the natural conservatism of risk policies and financial actors, will be gradual.

In my view, any concern about disrupting the fixed-income markets is entirely misplaced. Having worked in banking and dealt with bond and derivatives markets for a good long time, I see no chance of any market disruption from these changes, no chance at all. Also, having dealt with numerous financial regulators over many years, I see no chance of what one panelist called a regulatory vacuum. I do not think that will happen at all.

A final thought on timing. The NRSRO issue has been a regulatory issue and discussion for a decade in what seems to me a quite dilatory fashion, and I think the time would be very appropriate for Congress now to settle this issue of competition versus cartel in this key financial sector. In my view, this will bring, as the evolution proceeds, better customer service, more innovation, more customer alternatives, and reduce duopoly profits. Also, it will bring higher-quality credit ratings.

I think there is a certain analogy to publishing and the press in rating agencies, and we all know the more reporters you have working, the more likely the story is to come out. In the same way, in my view, the more credit rating agencies we have working on risk assessments, ideas, analysis, and looking at firms, out of this vibrant competition we are going to get better risk assessments.

Thanks again, Mr. Chairman, for the chance to be here.

Chairman SHELBY. I thank all of you.

The regulation of rating agencies begins and ends when the SEC staff issues the NRSRO license. Was the Department of Justice's Antitrust Division correct when it asserted that the NRSRO regime established, "a nearly insurmountable barrier to competition for new entrants?"

Mr. Pollock.

Mr. POLLOCK. I think the Department of Justice, Mr. Chairman, was absolutely correct in that opinion.

Chairman SHELBY. Mr. Partnoy.

Mr. PARTNOY. I agree. I think we have seen evidence of insurmountable barriers, and we will continue to see that unless we have action.

Chairman SHELBY. Mr. Stevens.

Mr. STEVENS. I think the circumstances speak for themselves. If it did not, there would be presumably many more NRSRO's than there are today.

Chairman SHELBY. Once the SEC staff issues the NRSRO license, what is the level of Commission oversight?

Ms. Cunningham.

Ms. CUNNINGHAM. None; very little.

Chairman SHELBY. Mr. Stevens.

Mr. STEVENS. You mean currently, Mr. Chairman?

Chairman SHELBY. Yes, sir.

Mr. STEVENS. I think it is slim to none.

Chairman SHELBY. Slim to none?

Mr. STEVENS. Probably more to the "none" side.

Chairman SHELBY. Mr. Pollock, do you agree with that?

Mr. POLLOCK. That is my understanding, as well, Mr. Chairman.

Chairman SHELBY. Would SEC oversight benefit investors and the markets?

Mr. Silvers.

Mr. SILVERS. Oh, I think undoubtedly. I think that is the main problem here. We have granted an unregulated monopoly in something where such harm can be done that to have substantive SEC oversight would be of huge benefit to working people in the markets.

Chairman SHELBY. Given that S&P and Moody's both have 99 percent, from what we have been told, of the corporate bond mar-

ket and profit margins that exceed 40 and even 50 percent, how would you assess the level of competition in the rating industry? Do the Big Two actually compete with each other or is it a duopoly or partner monopoly, as some economists have asserted?

Mr. Partnoy.

Mr. PARTNOY. I think you have heard consensus today, and the literature suggests that we have a duopoly, that this is not a market that is working well. It would be hard to find a market that is working worse where you had higher operating margins and greater oligopoly profit.

Ms. TILLMAN. If I may, Mr. Chairman?

Chairman SHELBY. Go ahead, Ms. Tillman.

Ms. TILLMAN. Being that I seem to be in the minority here, I would like to mention a couple of things that we believe need to be said. First of all, we believe that the NRSRO framework that was put in place did, in fact, have unintended consequences. Certainly, all you have to do is figure out how many years it has been in place and say that there are only five NRSRO's and that, in fact, it has limited the designation.

However, what we do believe is that there is a system in place or there are a number of actions that can be taken that would simply and effectively increase the level of competition, and for that matter allow the NRSRO's and any additional NRSRO's to review their processes and procedures on an annual basis, reporting back to the SEC and allowing the SEC to have discussions with them.

Chairman SHELBY. Mr. Reynolds, are investors in the markets disadvantaged by the absence of any real competition among the Big Two? In other words, what is the impact of all of this? Do they have unlimited pricing power?

Mr. REYNOLDS. Well, there are multiple levels. The first immediate one is when you have two firms dominating a market, it creates severe market disruptions. Market access, cost of capital, the ability to expand—it all wags on basically what I would argue would be one opinion rather than two, given the fact that the two very often operate in lock-step.

A comparable situation would be having only two investment banks can make over-the-counter markets in debt securities. If one changes their mind and the other one has a history of following, there is no second and third opinion, and people need a second and third opinion. And because they are issuer-based models, not investor-based, at the end of the day you do not get paid for having the best opinion by the investor. You get paid by the issuer for just providing those ratings, or I should say for not withholding ratings.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman. I know we have a vote on. I am going to put just a couple of questions because I am not going to be able to return if you continue the hearing.

I want to address something that may appear tangential, but I mean I think the basic arrangement needs to be examined carefully along the lines of the Chairman's questioning. Last year, *The Economist* wrote, "There are unsettling parallels to the disgraced auditing industry. The rating agencies are started up consulting businesses which advise on matters that might affect an issuer's ratings."

The Washington Post, in an editorial entitled "Rating and Raters," said "It is also troubling that the rating agencies are starting to sell consulting services. To secure contracts, the raters may be tempted to inflate grades for consulting clients. An acute version of this conflict of interest used to bedevil accounting firms."

Why should the rating agencies engage in these consulting services? Shouldn't an appropriate arrangement be that they are a rating agency, pure and simple? And you avoid the conflicts of interest that are associated with going into the consulting business for people that they are then going to rate?

Mr. DIERMEIER. Senator Sarbanes, I would definitely agree. It is not just a competition issue. This conflict in terms of consulting and ancillary services does create pressure. And since businesses and people that work in businesses understand how those pressures can manifest themselves, unless you have a clear, cut-and-dry rating process that is free from those conflicts, we are going to continue to have these kinds of problems. So, I think that the parallel is an excellent one.

Senator SARBANES. Ms. Cunningham, and then, Ms. Tillman, we will certainly give you an opportunity.

Ms. CUNNINGHAM. I could not agree with you more, and I think we have seen that the audit example is a perfect example of where even the self-policing just did not work. It is a bit like putting the fox in the hen house.

Senator SARBANES. Ms. Tillman.

Ms. TILLMAN. I would just like to state that Standard and Poor's rating services does not offer any consulting business, nor are any of its analysts involved in any consulting business.

Senator SARBANES. And you do that in order to avoid this charge of a conflict of interest?

Ms. TILLMAN. Well, not just because of that. It is because they are separate businesses and our code of conduct that we have in place does not permit analysts to be involved in any consulting business. And as I said earlier, the ratings services do not offer any consulting business.

Mr. PARTNOY. Senator, could I just point out——

Senator SARBANES. We have a lot of takers here. Real quick, because we have a vote.

Mr. PARTNOY. It might not be called consulting, but Standard and Poor's and Moody's offer services to issuers. For example, if an issuer wants to come to the agency to find out how a particular transaction might affect their rating, they can do so. So there certainly are these kinds of services being offered. They might not be called consulting, but they are consulting by any other name.

Ms. TILLMAN. If I could reply to Mr.——

Senator SARBANES. I will come back to you in a minute.

Ms. TILLMAN. Thank you.

Chairman SHELBY. Mr. Silvers.

Mr. SILVERS. Thank you, Senator Sarbanes. Two quick points. First, there is not a lot of data, at least not that I could find, that really gets at the question of how much consulting is going on not just by the silo that the firms will tell you about, but by all of their affiliates and all the things that are not called consulting, but might be consulting.

Second, I think it is really worth the Committee's attention to the fact that these issues of conflicts and the quality of ratings dwarf the issues around pricing. The collapse of Enron literally wiped out in debt more value than the entire market has placed on Moody's, which is the market's value of essentially all of the bad pricing that other witnesses have been talking about. But one catastrophe bred by conflicts is of greater consequence than all of that, which is frankly why my testimony focused on managing those.

Senator SARBANES. Mr. Stevens.

Mr. STEVENS. Senator, it seems to me we need more participants in the market and we need to know a lot more about all of those participants so that people who use these ratings can judge them. And if we have conflict of interest disclosure that is detailed enough and that is current enough, then the users of ratings can determine whether the rating is worth it or not.

Senator SARBANES. Ms. Tillman, you wanted to add something?

Ms. TILLMAN. Yes, just a couple of points.

Senator SARBANES. The last word, I think.

Ms. TILLMAN. One, we agree that Enron was a tragic situation and certainly hurt and was harmful to many people. But we were also victimized. As was stated in a plea agreement, the rating agencies were purposefully deceived. Literally, the executives of Enron sat down and put a plan in place to deceive the rating agencies so that they would not lower the ratings.

On conflicts of interest, the weight of opinion by market participants is that the issuer-paid model does not compromise the objectivity of the rating. In numerous surveys, responses, and comments to regulators both here and abroad, they have found no occurrence of conflicts of ratings, or if there is, they have been well-managed.

Therefore, you know, I believe that the issuer-paid model also offers something that we do not talk about, and that is the benefits of disseminating information for free, disseminating media analysis, disseminating the reasons and rationale for those ratings.

One other clarification. We are paid to do analysis. We are not paid to publish it, and we freely publish it so that the investing public is aware of what the creditworthiness is of the issuers and the securities in the market.

Senator SARBANES. Let me ask one quick question. What is the view of panelists on whether the director of a rating agency—let me put it the other way—that the chief executive officer or director of a company that is being rated should also be the director of the rating agency? Is that a problem? It seems to me if it is, it is pretty easy to fix.

Mr. SILVERS. Senator, I think that the ideal governance of a rating agency would be that the board would be composed of individuals who did not have an economic interest in any way in the ratings that were being done. That being said, it is fairly easy to wall off that particular conflict, but the real question, I think, is why is that conflict necessary? There does not seem to me to be a good reason why you have to have that conflict in the first place.

Senator SARBANES. Thank you.

Chairman SHELBY. We appreciate you coming. We are controlled by the floor, as you know, and we have a big vote on the floor now.

I have a number of questions to ask all of you and I would like to do that for the record. It will be part of this hearing record. We will follow up with all of you and go from there. We appreciate your participation here today.

I would just like to sum up with one thought. What is wrong with competition? What is wrong with transparency, competition, and healthy oversight?

Mr. Pollock, you have been here many times.

Mr. POLLOCK. Absolutely nothing, Mr. Chairman.

Chairman SHELBY. We preach competition, do we not?

Mr. POLLOCK. You have just said it all.

Chairman SHELBY. Thank you so much.

The hearing is adjourned.

[Whereupon, at 11:26 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT, INVESTMENT COMPANY INSTITUTE

MARCH 7, 2006

Introduction

Good morning. I am Paul Stevens, President of the Investment Company Institute, the national association of U.S. investment companies. ICI members include 8,579 open-end investment companies or "mutual funds," 653 closed-end funds, 162 exchange-traded funds and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.1 trillion, representing 98 percent of all assets of U.S. mutual funds. These funds serve approximately 89.5 million shareholders in more than 52.6 million households.

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, it is an honor to appear before you today for the first time as President of the ICI. Mutual funds and fund shareholders have a significant stake in the soundness and integrity of the credit rating system. I therefore commend the Committee for holding this hearing to examine the current oversight and operation of credit rating agencies.

As the ICI has noted in response to several proposals from the Securities and Exchange Commission relating to credit rating agencies and NRSRO's and in other statements relating to NRSRO oversight, credit rating agencies play a significant role in the U.S. securities markets generally, and vis-á-vis mutual funds in particular. The ratings published by credit rating agencies help inform the investment decisions of mutual funds and other institutional investors. In addition, the SEC and other government agencies rely upon these ratings as indicators of investment risk for various regulatory purposes. Maintaining the integrity and quality of the credit ratings process is therefore essential to sustaining investor confidence and to promoting the proper functioning of our capital markets.

As I testified recently before the House Financial Services Committee, we believe it is timely and appropriate for Congress to consider legislation to advance several objectives in this area. First and foremost, legislation should facilitate the designation of more rating agencies as NRSRO's in order to introduce much needed competition in the credit rating industry. Creating competition would provide NRSRO's even stronger incentives to ensure that their ratings are of the highest quality and reliability. Second, to ensure the continued integrity and quality of these ratings, legislation should ensure appropriate SEC oversight of NRSRO's. Third, legislation should ensure disclosure of information about NRSRO's to investors and provide them a continuing opportunity to evaluate NRSRO's, thereby promoting efficient functioning of the credit rating industry. Finally, legislation should ensure that NRSRO's have some accountability for their ratings processes in order to provide them with incentive to analyze information critically and to challenge an issuer's representations.

Importance of Credit Rating Agencies and NRSRO's to the Fund Industry

Use of Credit Ratings

Reforms to the oversight and operation of credit rating agencies are critical to ensuring the continued proper functioning of our securities markets. Like other institutional investors, mutual funds utilize ratings issued by credit rating agencies in analyzing the credit risks of securities. In fact, NRSRO-rated securities form an important component of the portfolios that funds manage for the benefit of their shareholders. For example, money market funds currently hold $2 trillion in assets. The ICI estimates that taxable money market funds invest about 50 percent of their nongovernment portfolio securities in NRSRO-rated securities. In addition, according to one source, tax-exempt money market funds invest an even larger amount, approximately 90 percent of their assets, in securities rated by NRSRO's.[1]

Credit ratings also play an important role in communications between funds and their shareholders—communications that inform the purchase decisions of millions of American investors. Many funds incorporate ratings criteria into shareholder disclosures regarding the investment policies and strategies of the fund. For example, such disclosure may include a description in a fund prospectus regarding the percentage of its portfolio invested in bonds rated in a particular category by an NRSRO. Many corporate and municipal bond funds now provide shareholders with a graph or table showing the percentage of the portfolio invested in each rating category of one or more NRSRO's. Some funds even provide the ratings of individual

[1] iMoneyNet, Money Fund Report (February 24, 2006).

securities in the schedule of investments provided to shareholders as a method of communicating with shareholders about the credit risks taken by a fund.

Ratings also play an important role in the valuation of mutual fund shares. Many mutual funds use pricing services in valuing debt securities, some of which trade only infrequently. The rating assigned to securities by a rating agency may influence the valuation determinations of pricing services and ultimately the calculation of the net asset value of mutual funds that hold such securities.

Finally, some investment companies, particularly institutional money market funds, obtain credit ratings for their own shares.

Money Market Funds and Investment Company Act Rule 2a–7

The most significant influence of credit ratings on the fund industry is on the $2 trillion invested in money market mutual funds. Money market funds are a truly remarkable chapter in the history of U.S. mutual funds. Initially, money market funds were used as savings vehicles; today retail and institutional investors alike rely on them as a cash management tool, because of the high degree of liquidity, stability in principal value, and current yield that they offer. ICI estimates that between 1980 and 2004, roughly $100 trillion flowed into, and the same amount out of, money market funds.

If money market funds are an industry success story, they also most certainly are an SEC success story. Since 1983, money market funds have been governed very effectively by Rule 2a–7 under the Investment Company Act of 1940. Since Rule 2a–7 was adopted, money market fund assets have grown nearly 1,000 percent (from $179 billion to $2 trillion).

Rule 2a–7 limits the types of securities in which money market funds can invest in order to help them achieve the objective of maintaining a stable net asset value of one dollar per share. Credit ratings form an integral part of these limitations. For example, under Rule 2a–7, money market funds may invest only in securities that are rated by an NRSRO in its two highest short-term rating categories or, if unrated, that are determined by the fund's board of directors to be of comparable quality. In general, money market funds also cannot invest in certain securities, including most asset-backed securities and certain guarantees, unless they have been rated. Finally, Rule 2a–7 requires money market fund advisers to continuously monitor the ratings of portfolio securities and to take certain actions in the event a security is downgraded. While Rule 2a–7 does not completely limit money market funds to rated securities, it effectively requires fund advisers to incorporate any available ratings into the analysis of appropriate securities to be held by these funds.

It is important to note that no government entity insures money market funds, as the FDIC does bank deposits. Nevertheless, despite an estimated $200 trillion flowing into and out of money market funds over the past 25 years, through some of the most volatile markets in our history, only once has such a fund failed to repay the full principal amount of its shareholders' investments. In that case, a small institutional money fund "broke-the-buck" due to extensive derivatives-related holdings.

It is critically important that this record of success achieved under Rule 2a–7 continues for the benefit of money market fund investors. This, in turn, depends on the ratings issued by NRSRO's providing credible indications of the risk characteristics of those instruments in which money market funds invest.

The NRSRO Designation Process Should Promote Competition

The mutual fund industry is one in which intense competition has brought unparalleled benefits to investors. I firmly believe that robust competition for the credit ratings industry is the best way to promote the continued integrity and reliability of their ratings. Unfortunately, the current designation process does not promote—but, in fact, creates a barrier to—competition. Since the SEC first created the NRSRO designation in 1975, only a handful of rating agencies have achieved this status. Given the competitive advantage and benefits that accompany the NRSRO designation, it is hard to imagine that other existing credit rating agencies or potential new entrants to this market would not want to obtain such a designation. Nor are new rating agencies likely to be able to compete effectively without the NRSRO designation.

The advantages and benefits of NRSRO designation are significant. For example, because of the requirements discussed above on the types of investments that money market funds can make, it is necessary for many issuers to have their securities rated by an entity designated as an NRSRO (as opposed to a rating agency without such a designation) to avoid losing access to a substantial pool of investment capital. Similarly, ratings from an NRSRO may give issuers access to investments from State and local governments, which often are required by law to invest in securities

with specified ratings. Broker-dealers, too, have an incentive to hold NRSRO-rated securities in order to maintain their capital adequacy under the Federal securities laws. Given the valuable attributes accompanying the NRSRO designation, issuers and other users of credit ratings have little incentive to pay for the ratings of an agency that does not qualify as an NRSRO, even if they believe that the ratings themselves may be of superior quality. This lack of competition eliminates an important incentive for NRSRO's to maintain and improve the quality of their credit ratings.

To encourage more competition, the NRSRO designation process must be improved. The current SEC process for designating credit rating agencies through the issuance of no-action letters has not worked effectively. We share the concerns of others regarding the length of time necessary to obtain a no-action letter and the limited types of credit rating agencies deemed eligible for NRSRO status. The SEC's vague "national recognition" standard gives rise to the oft-noted "chicken and egg" dilemma: An organization must be nationally recognized to be designated as an NRSRO, but cannot realistically expect to obtain national recognition without the NRSRO designation. These factors all have contributed to the small number of currently recognized NRSRO's.

We believe the best way to address concerns regarding the current NRSRO designation process is to replace the current no-action process and "national recognition" standard with a mandatory, expedited NRSRO registration process with the SEC.

NRSRO's Should be Subject to Effective Regulatory Oversight

The implementation of such a NRSRO registration process undoubtedly would spur competition. At the same time, to ensure the integrity and quality of credit ratings, there must be effective regulatory oversight by the SEC of NRSRO's after their initial qualification. We believe this can be achieved through a combination of (1) periodic filings with the SEC, and (2) appropriate inspection authority for the SEC, coupled with adequate enforcement powers.

Currently, the SEC has little basis on which to assess the continued credibility and reliability of credit ratings issued by an NRSRO after it has received its designation through the no-action process. It is my understanding that NRSRO's are subject to infrequent, if any, SEC examinations. In addition, under the terms of the no-action letters granted to NRSRO's, once a rating agency has been granted the NRSRO designation, it is required to notify the SEC only when it experiences material changes that may affect its ability to meet any of the original recognition criteria. Given the heavy financial impact that a loss of NRSRO designation would have on a rating agency, NRSRO's have a strong disincentive to report any such changes. It is impractical to premise regulation altogether on self-policing and self-reporting.

For these reasons, credit rating agencies should be required to provide certain information to the SEC upon registration, such as information relating to conflicts of interest, the procedures used in determining ratings, ratings performance measurement statistics, and procedures to prevent the misuse of nonpublic information. We believe that NRSRO's also should be required to report affirmatively to the SEC, on an annual basis, that no material changes have occurred in these areas. Similarly, NRSRO's should be required to report any material changes that do occur on a timely basis, and this information should be made available promptly to investors who rely on NRSRO ratings.

Finally, it is important that the SEC have inspection authority over NRSRO's and devise an appropriate inspection process with respect to NRSRO's. Such a process can and should be tailored to the nature of their specific business activities. Nevertheless, some form of periodic examination seems imperative in light of the important and pervasive role that credit ratings play in the securities markets.

While changes to NRSRO oversight would go far in ensuring that ratings issued by NRSRO's are credible and reliable, as part of any changes to the NRSRO regulatory scheme, the SEC should be directed to reassess its existing regulations that rely on and refer to NRSRO's. For example, the credit rating requirements in Rule 2a–7 will need to be reexamined if there is a significant increase in the number of NRSRO's to avoid funds having to monitor the ratings from each of those organizations.

Transparency of Information to Investors Should Be Increased

In discussing these issues with our members, they have emphasized the importance to them, as investors, of access to information about an NRSRO's policies, procedures and other practices relating to credit rating decisions. In particular, it would be helpful for NRSRO's to disclose to investors their policies and procedures

addressing conflicts of interest (as well as the conflicts themselves), and periodically to disclose information sufficient for investors to evaluate whether they have the necessary staffing, resources, structure, internal procedures and issuer contacts to serve as NRSRO's. The call for increased transparency on these subjects is not new. In its report on the role of credit rating agencies, submitted pursuant to the Sarbanes-Oxley Act of 2002, the SEC noted that at its hearings on credit rating agencies, representatives of buyside firms, including mutual funds, had stressed the importance of increasing transparency in the ratings process.

It is therefore important that any legislation in this area ensure disclosure of information about NRSRO's to investors. We believe the public disclosure of this information would allow investors a continuous opportunity to evaluate an NRSRO's independence and objectivity, capability and operation. Such disclosure would serve as an effective additional mechanism for maintaining the integrity and quality of credit ratings.

NRSRO'S Should Be Accountable for Their Ratings Processes

NRSRO's should assume some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations. Under current regulations, the SEC exempts NRSRO's, but not other rating agencies, from treatment as experts subject to liability under Section 11 of the Securities Act of 1933 and, thus, allows NRSRO ratings in prospectuses and financial reports. Although the SEC has stated that NRSRO's remain subject to antifraud rules, the NRSRO's have steadfastly maintained that, under the First Amendment, they cannot be held liable for erroneous ratings absent a finding of malice.

Notwithstanding whether NRSRO's can or should be held liable for an erroneous rating itself, we believe that any reforms to the credit ratings process should, at a minimum, make NRSRO's accountable for ratings issued in contravention of their disclosed procedures and standards. Even if the First Amendment applies to credit ratings, it does not prevent Congress from requiring rating agencies to make truthful disclosures to the SEC and to the investing public.

Conclusion

The SEC has been aware of issues relating to credit rating agencies for over a decade now. During that time, the SEC has issued two concept releases, two rule proposals and a comprehensive report to Congress addressing credit rating agencies and NRSRO practices. In the process, the SEC has received scores of comment letters, including several from the Institute, urging action in this area. None has been forthcoming. In light of this history, action by Congress is now necessary.

I very much appreciate the opportunity to share the Institute's views with you today. I look forward to working with the Committee on these and other issues.

PREPARED STATEMENT OF GLENN L. REYNOLDS

CHIEF EXECUTIVE OFFICER, CREDITSIGHTS, INC.

MARCH 7, 2006

CreditSights welcomes the opportunity to comment on the evolving framework for credit rating agency oversight. As a growing provider of various credit research and analytical services selling to many of the same customers that use credit ratings services, CreditSights has in the past had the opportunity to provide input into the review of the NRSRO framework. We have noted in past testimony and would like to note again that we have never applied for NRSRO status and have no plans to do so any time soon. From the standpoint of CreditSights, the cost and effort involved was not worth it for our firm given the track record of companies seeking to enter the NRSRO space. While we do compete with some of the NRSRO's in providing alphanumeric ratings through our statistical default risk model, our main business line is not "ratings." Operating primarily in independent credit research areas outside of "ratings" was as much a necessity for our own company to achieve growth as it was a strategic need since the current system frustrates expansion in the ratings business, and is likely to continue to do so unless change is brought soon.

Despite the dramatic change that has taken place in the debt markets and all of the opportunities that these changes bring to providers of research, credit ratings, risk management products, and data services, it is striking that there remains virtually no meaningful competition, and the ratings industry has solidified into what has frequently been described as a partner monopoly between Moody's and S&P.

The stark contrast with the competitive industry structure in the underwriting business is also very notable. Protracted inaction in reforming the regulatory framework has allowed the incumbent NRSRO's to stack their natural barriers to entry even higher during the past period of prolonged debate, with the NRSRO's themselves working overtime in their attempts to slow change and keep the status quo in place as long as possible. Since we are in the business of watching how profit-maximizing industries evolve, the desire of the duopoly to hold onto their advantage is certainly understandable. Those are normal economic instincts. It is clear at this point—and after 4 years of picking over the details since Sarbanes-Oxley—that the NRSRO end game is to slow if not prevent change. We suspect that just slowing it down is a more realistic goal for them, since change is inevitable.

Some action is required soon since a lot of time has been lost in debates and constructive reform measures can be achieved without burdensome or disruptive regulation. Pressure will already be on new market entrants to bring innovation and some incremental quality to the market, but new entrants should not also be faced with the need to hurdle and leapfrog regulatory barriers. It is painful to watch how Moody's and S&P want to shape the criteria process now with the SEC even if in part just to keep the debate going and stall the process. At the same time, they do not want to be formally accountable to anyone but themselves. Our comments below and in past testimony on the template for change revolves around a few key points, and the general themes still apply:

- Immediate and radical lowering of barriers will not bring similarly immediate change in market structure since Moody's and S&P will continue to dominate the ratings industry for some time. It will diminish as the market grows and more competition comes into the market, but it will be a slow process. A revolution in the rules will still simply lead to slow evolution in the credit ratings industry. The continued market share dominance will be based on natural commercial barriers which the incumbent NRSRO's—with their deeply imbedded regulatory right of way—have been able to build upon through steady expansion and acquisitions, including moves outside of the ratings business during a period of rapid global growth and product evolution in the debt markets.
- The next structural evolution for this industry also should open up the avenues for well-capitalized players from the related financial information, technology, and data industry. The NRSRO reform process should not be just about streamlining the "slow queue" and "criteria debate" process that now serves as the Plan B for Moody's and S&P. A system that objectively lowers the barriers will be harder for the incumbent NRSRO's to control since it will be based on letting in the markets work. On the other hand, the framework the agencies would applaud is one that can be lobbied and "lawyered" to death by the incumbents to impede meaningful competition from financial firms of global scope. We have already seen samples of this in the SEC Proposed Rule Process.
- Allowing for new market entrants will not be disruptive to the markets for the very reason that Moody's and S&P will still dominate for the intermediate term, and the fact that most investment parameters name them specifically. Minor administrative changes for those who use the NRSRO designation generically is fairly routine and just part of the daily work flow that is normally handled in shareholder proxies, the investment committee process, or standard risk management decisions by investment professionals. Moody's and S&P will throw out the fear of the unknown and use some time-honored fear mongering ploys citing "disruptions" to undermine change.
- The economic inefficiencies and market distortions of the current regulatory structure are too glaring to ignore. Moody's and S&P's pretax margins eclipse those of Microsoft and dwarf Exxon Mobil to name a few of the corporations typically tagged as 800-pound gorillas in their respective markets. With all due respect to the ratings business, this is not high tech rocket science, the financial discipline itself is fairly straightforward, there is a growing supply of available research talent not only given the changes on Wall Street but also with each new business school graduating class around the world.
- There has never been a more opportune time for the barriers to come down as Wall Street totally redefines its business strategy and traditional sell-side research starts to unbundle from the underwriting businesses. Moody's and S&P have already been pushing in substance into those businesses with their new suite of product offerings and have come closer being in the buy-hold-sell research business than they ever have been. Without change in the credit ratings sector to open it up to competition, Moody's and S&P will grow even more dominant and market distortions will be even greater.

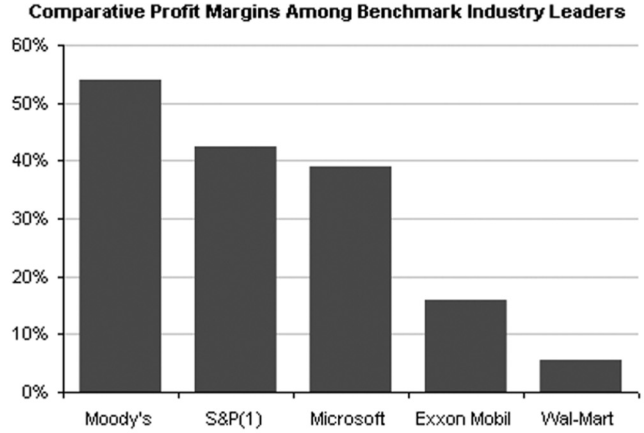
One thing is certain. If the barriers come down, high quality and well-positioned market entrants will come to compete. The opportunities in the global credit markets have never been greater, and global growth in a range of security classes and financial products has never been so attractive. Moody's and S&P can still execute on global expansion in new regions, new products, and new nonratings services whether from the staging platform of protected NRSRO status or in a truly competitive market. The best outcome is that their growth will not be tied to anachronistic regulation guaranteeing them clients regardless of their performance. They will prosper one way or the other, and their obstructionism around change just reflects their desire to keep the potentially insurmountable head start going for a few more years. More than a quarter of a century was apparently not enough.

That protected status they still enjoy raises risks for potential market entrants including well-capitalized content aggregators that could be looking for horizontal expansion opportunities. It is hard enough competing against entrenched financial giants with inherent commercial advantages (client base, brand power, enormous financial flexibility) without keeping the ratings behemoths on regulatory steroids. There has already been legislation proposed that takes the process out of the hands of Moody's and S&P, who would both like to control the "standards debate" and keep the equivalent of a waiting period in place for a protracted time frame. Just about every recommendation they have made promotes delay and narrows options for entrants. It is getting tired and has been overindulged.

The Artificial Barriers Impair Competition and Efficiency

There is every reason to expect a lot of interest in entering the credit ratings market. According to Economics 101, high profits, high margins, high growth, and high prices in an industry attract market entrants. As we look across similar examples of leading players in other industries, the extraordinary case of Moody's and S&P continues to stand out as an anomaly, and in particular with respect to the absence of competition, the enormous pricing power, the price-insensitive volume growth, and the lack of choice for consumers. In the attached chart we compare the pretax margins of Moody's and the financial services business segment of McGraw-Hill (the unit is dominated by S&P) to a few other major corporations sometimes accused of everything from price-gouging to the pursuit of global domination. Even if one feels Exxon Mobil and Microsoft are misunderstood, the comparison is telling. Moody's pretax margins dwarf those of Exxon Mobil as well as Microsoft, and Wal-Mart is a comparative pauper in profit margins given that its strategy is based on low prices and low costs and that Wal-Mart serves the more price-sensitive consumer. We would not be taking a risk to say that corporate issuers would be more price-sensitive also if they were in fact given the opportunity to have a choice.

Comparative Profit Margins Among Benchmark Industry Leaders



Note: Based on pre-tax margins for most recent trailing 12 month reporting period.
(1) Based on the financial services segment operating income of McGraw-Hill.

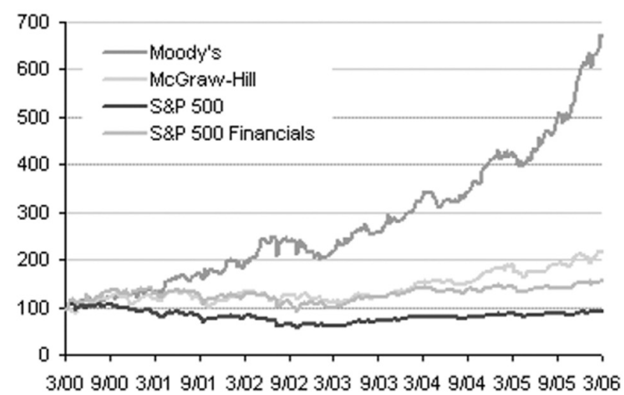
Imagine a scenario where the government controlled oil reserves and told Exxon they were the only ones that could drill in those areas. Imagine a no-action letter being required to be a seller of software and Microsoft not only was the only one approved but was still able to spend its massive profit margins on the full array

of technologies outside of that limited but very lucrative product segment. Imagine again that a slice of those massive margins could be set aside every year for lawyers to hinder regulatory change. Imagine Wal-Mart being handed the best retail locations by a government oversight body with virtually no other retailers given the right to lease and compete regardless of their business model. Imagine in all of those situations small to mid-sized firms that had competitive products were not given the opportunity to grow or compete due to regulatory hurdles. Or imagine a larger firm looking to enter that market and was prevented from doing so since it would be in effect a new business venture with the theory being you cannot enter a business unless you are already in it. That last one is a difficult equation to solve. In fact, you cannot enter it even if you have the capital and some inherent synergies. Those are ludicrous enough scenarios to see as unrealistic, but absurdly enough there is a high degree of parallel to what the NRSRO duopoly actually has been afforded over the decades.

A Valuable Opportunity Exists Now for Competition

The fact that there have been virtually no meaningful market entrants into the NRSRO space—and in fact a considerable level of consolidation among the NRSRO incumbents and aspiring ratings firms, has all been well covered in prior hearings in Congress as well as at the SEC. The performance of the lead players certainly nonetheless should attract attention from a wide range of market participants in the financial services space. The financial performance of Moody's as the one NRSRO pure play in the market has been nothing short of extraordinary. Since mid-1998, when what later became Moody's was split off to trade largely on its own fundamentals, the total return on Moody's stock has been over 501 percent vs. only 28 percent for the S&P 500 and 55 percent for the S&P 500 Financial Index. McGraw-Hill (S&P's parent company) has returned 204 percent over that same time span. McGraw-Hill's lucrative financial business is housed within a more mature and lower margin pool of other businesses, so it underperformed Moody's but still crushed the overall market.

The NRSROs Have Held Up Well Under The Regulatory Challenge



Source: Bloomberg. Note: 3/3/00-3/3/06. Returns rebased to 100.

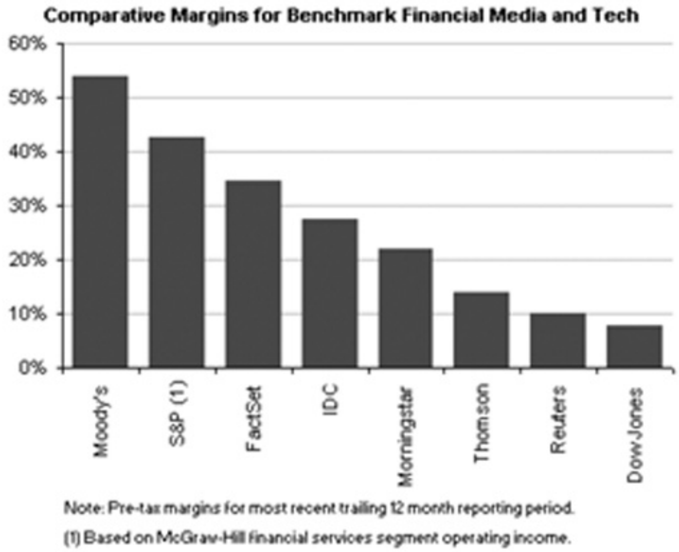
The success of Moody's and McGraw-Hill against this backdrop is hardly a major surprise. The growth prospects for them remain compelling, and they have been able to counter and stall the lowering of barriers with considerable skill. What is most stunning is that such a favorable backdrop has not brought more concerted attempts to enter the space. That is something for the Committee to ponder as they look to institute reform. The lack of new NRSRO's has to be clearly laid at the feet of the traditional regulatory framework, and there needs to be rapid change if the policy goal is to promote competition and rid the market of entrenched barriers. The 4 years since Enron have blown by rather quickly, and there have been a lot of hearings and a lot of testimony filed here and filed there. Some action is long overdue to get the real process of fostering competition on track and out of the discussion stages. The regulatory follow-through itself will necessarily be evolutionary, but the regulatory fear-mongering by the rating agencies is starting to get very repetitive even as it is misleading.

The Path to Real Competition is Straightforward

As regulatory change is being weighed to more rapidly lower barriers and expand competition, we would caution against taking one artificial set of barriers and replacing it with another as some have recommended. If there is one thing we are totally certain about in all of this process, it is that Moody's and S&P are not staying up late at night worrying about small boutiques getting cleared to do business in their space, and they are not even worried about another Fitch or A.M. Best or two coming along. They are worried about large well-capitalized institutions that offer the market the opportunity for choice across the globe, have capital to invest to buy and/or build competitive capabilities, or have many of the attributes that Moody's and S&P themselves are looking to expand upon as they buy assets and capabilities around the world. Their fears should be a signal to policymakers of how to rewrite the rules so one inefficient structure that impairs real competition is not just replaced with a slightly less inefficient one that just lets in a few minor players. Such a change could also address some of the worries that linger about fly by-night operations setting up shop and diluting rather than enhancing the quality of information that is being delivered into the marketplace.

In considering what structural evolution in the credit ratings industry will bring on the most rapid change and encourage innovation, we would recommend walking in the shoes of Moody's or S&P for a while. Basically, if it worries them it is probably a good thing. While clearly their wish is for the status quo so they can continue their partner monopoly, face no exposure to liability, and be subjected to no regulation (other than that which keeps competition out that is), their biggest worry is that the new template for competition will also allow a route for well-established, well-capitalized companies in the financial media, technology, and data sectors to rapidly enter the credit ratings space. These types of operators cut across many different subsectors of the financial information and technology industries, and both Moody's and S&P have in part entered or expanded in some of their businesses in recent years. The NRSRO's have been able to do so from their protected space in the ratings business while those other firms—with all of their extensive capabilities—have to sit on the sidelines and watch since they have not been in the ratings business. They easily could be with the right reform measures.

The companies that have any combination of global reach, proprietary content, existing distribution networks, established customer relationships, and varying degrees of brand power are the companies that create the real threat to the current ratings duopoly. We should qualify up front that the names of the companies are based on our own theories as to which ones could easily fit into the ratings industry, but the list of potential names could include a range of multibillion-dollar corporations such as Bloomberg, Thomson, Reuters, Bertelsmann, Morningstar (leading rater of Mutual Funds), FactSet (a leader in financial data and work flow products), IDC (securities pricing, analytics, financial technology), Morgan Stanley Capital International (leader in international indices, owner of Barra in financial analytics), and Dow Jones among others. With the rapid globalization of the credit markets and especially the euro debt markets, international expansion opportunities and more analytically intensive market segments require proprietary technologies and global reach that many of these companies currently possess.



We would argue that the fallback position for Moody's and S&P at this point is that if their First Amendment gambit fails to hold back any regulation and fails to scare away legislative initiatives, they will push for a return to the NRSRO criteria debate that can keep eating up years and slowing the process of market entry for such global players as those noted. Those criteria debates can be buried in lobbying and backroom point-counterpoint that can eat up another 4 years very quickly. The SEC has limited budget and limited manpower, and the ability of Moody's and S&P to frustrate the process has been evident. We certainly have seen that demonstrated since the initial Sarbanes-Oxley legislation and subsequent to the mandated March 2002 Senate hearings on the rating agencies. We suspect that Moody's and S&P would also like a return to the "slow queue" strategy with the SEC where more of these larger strategic players can get pushed further back in line. To the extent that happens, the regulatory uncertainty will keep out most of these companies if not all of them since the uncertainty of "club membership" would be too unpredictable a risk factor. There are simply too many other business initiatives serving the growing markets that can provide an immediate return.

It is clear that streamlining the process for the entry of new, credible, and viable providers of credit ratings services will attract new ratings organizations from the current population of small to mid-sized competitors both in the United States markets as well as from Europe and the Asia-Pacific region who are looking to establish a global footprint to rate issuers across multiple currencies. The much-discussed chicken-and-egg debate around "nationally recognized" should be put to a market test and move beyond the batteries of lawyers and interest groups that continue to weigh in. There is nothing more consistent with the principle of free, competitive markets than lowering barriers and allowing for new market entrants to bring innovative, high quality products to potential customers. Issuers will have more choices as will investors and consumers of credit risk assessment products and services. In the end, the regulators should let the market decide. If a major institutional investor writes a check to a research company or a rating agency, and then keeps renewing, that ratings provider and research service should be deemed credible. Backroom negotiating, expensive lawyers, and good lobbyists should not be the swing factor. That would allow for more information in the market—not less—and from both large firms and small firms. We have not figured out yet how that can be a bad thing.

For those who want to consider the ratings business from a policymaker's standpoint rather than as an operator in that market, we would also highlight that lowering barriers creates jobs, inherently promotes price competition, and brings efficiency to the market along with choice to the consumer—whether that consumer is an investor or an issuer. We would argue that lowering barriers to allow more ratings agencies to be quickly assembled on a buy-and-build basis by larger firms

would also encourage more analysts to take some entrepreneurial risk in this space. That creates jobs and will do so in more states than just the traditional financial hubs.

New Entrants Build Businesses by Selling High Quality Information, Not High Ratings

One of the concerns that has been raised around the lowering of barriers is that more rating agencies will flood into the marketplace and dilute quality, inflate ratings to "buy business," and that the risk to "widows and orphans" will grow if they rely on disreputable firms. In addition, there is the natural worry that quality will be diluted if barriers come down too quickly. We can put aside the debate for now as to what quality starting point we are at now with an industry dominated by a duopoly that in the end is not paid specifically for quality or held to any standards of accountability other than a self-imposed one. We need to judge the "quality risk" factor against what opportunities might be lost. The flip side of the barrier-to-entry debate is that high barriers keep out competition that can bring innovation, highly experienced personnel, specialized skill sets in new areas such as international credit, the non-U.S. corporate sector, securitization, the analysis of structural risks and specialized securities, and also attracts more entrepreneurial organizations that look to cater to the institutional investors demands for high-information-content ratings and research—not just a few letters and numbers that are strung along as a grading of default risk.

We would highlight that even with the creation of a new rating agency that sought to build business with issuers by inflating ratings, we would argue that particular ratings company would face the simple reality that the issuers would not be likely to pay them enough to build a business and that any such operations would be a nonfactor and fade away. Perpetuating the fear of ratings inflation is strategically an old ploy the NRSRO's use. It must be partly rooted in the odd assumption that investors want to be lied to and misled and would take any such firm seriously. We would agree it is more the case that issuers want to be flattered in their ratings for corporate ego or for purposes of low cost execution, but with no market clout comes no benefit to the issuer from a grade-inflating upstart. So why pay him? That ratings inflation game worked for a while in the commercial paper business in the 1980's, but the market's sophistication has now moved far beyond that. Ironically, some of those ratings inflation shops from the 1980's were later rolled up into other NRSRO's in mergers, and they are also kicking around this fear today. So much for no shame.

This theory on a new wave of "ratings shoppers" also ignores the ever-growing base of investors and risk managers that look for information to hedge credit risk on the downside for defensive purposes (the banks, brokerage houses, and a growing base of global institutional investors, corporate users managing customer risk and supplier chain risk, etc.) So new market entrants would be better served by a value-added, investor-based model—not an inflated issuer model that is not likely to bring much revenue anyway. Since a cornerstone of the NRSRO's new product strategy is rooted in risk products and serving the needs of the BASEL framework and supplying "warning system" products that flags downside risks, the agencies actually know this line of reasoning is nonsense. They will spin it anyway, since they have an axe to grind to keep out new market entrants. The bottom line is that being early on calling the negative trend is a great way for new players to expand in this business, not the other way around.

The accusation that new rating agencies will be unduly positive also ignores the rapidly growing base of investors (hedge funds, the Wall Street firms themselves) that use negative information for "offense" by shorting securities or in the credit derivatives markets. The derivatives market is a gold mine for the agencies, so the fear of a race to the bottom that they often spin around new market entrants belies the growth opportunities they themselves see. There is revenue to be generated in being right—whether positive or negative.

In the end, investors are not in the habit of wasting their money and for that matter issuers and intermediaries are more than a little realistic around the value of a new upstart in handing out high grades. The path to the current duopoly is littered with those that used a ratings inflation strategy tied to an issuer-pays model. The bulk of such agencies disappeared or were simply rolled up into other NRSRO's via the consolidation process we have seen over the past 15 years. Business models that will be most "disruptive" to the traditional issuer-pays ratings model are those business lines that offer value to investors—not issuers. The incumbents have a lock on the issuers for now, and any company that looks to issuers for revenues will face an uphill battle.

New Rating Agencies, the NRSRO Designation and "Market Disruptions"

The NRSRO's have been remarkably adept at interpreting support for the "NRSRO concept" as implying that elimination would be highly disruptive to the market. Based on these supposed disruptions, the NRSRO concept must be preserved at all costs since volatility lurks. At least that is how the story goes. The fear of the unknown can be an effective weapon, and the NRSRO's are looking to use it to the fullest. Adding more input and innovation, and growing the scope of the human and financial capital and technology directed at this growing market is more likely to be disruptive to Moody's and S&P's margins than the capital markets. Whether the NRSRO framework is streamlined and made more transparent or whether it will be tortured by regulatory bodies looking to reverse engineer a rating agency is the decision point. The incumbent NRSRO's would like to keep the ratings agency reform process in the position paper and point-counterpoint process with the SEC, so they can use as much influence, backroom lawyer gamesmanship, and third party lobbying to keep the process flying circles around the main issue—that the market should simply be opened up. That will attract the natural base of well-capitalized competitors with global scale and will also lower the impediments to capital flows into the ratings agency sector from sources of private equity that will fund the growth of new market entrants.

The red herring of "market disruptions" in general is something the incumbent NRSRO's like to wave to stall change. We would highlight that taking the barriers down to zero tomorrow will not change the basic competitive playing field for years and Moody's and S&P will still dominate. It is not as if a new definition of NRSRO (or its elimination) will cause Moody's and S&P to dry up and blow away. Put the use of ratings in market context before buying into that rating agency ruse. The bulk of institutional investors have credit ratings parameters that set out requirements for average ratings or minimum ratings for securities they own in their portfolio or for counterparty risks. These parameters usually more often than not specifically cite Moody's and S&P and not "any NRSRO." The natural barriers to entry are thus enormous to begin with for any new agency, and it will take a considerable amount of clout to get more banks and securities houses to include a new agency in their underwriting process. Ratings-based pricing grids in bank loan agreements, ratings triggers built into bond and bank loan terms, ratings-based haircuts on loans used in setting margins on debt securities as collateral, over-the-counter swap agreements that include ratings-based termination provisions, internal credit limits by issuer in portfolios, and many other risk management practices cite the specific rating agencies—namely, S&P and Moody's. So even eliminating the NRSRO designation would have scarce effect of the great bulk on those market exposures where the specific agencies are named.

For those mutual funds such as money market funds that have minimum ratings using the more generic term "NRSRO" under Rule 2a–7, the process of naming specific agencies could simply be a resolution as part of fairly routine administrative exercises that go into frequent board meetings, proxies, and/or investment committee exercises that include many other items routine voted upon or "gaveled in." For a new rating agency to crack into the "approved list of agencies" at an institutional investor, that ratings provider would need to deliver quality, value, and be an organization that would make such an exercise worthwhile for the customer. As the panic around quality dilution and disruptions are hyped by the incumbent NRSRO's, it is worth keeping in mind that organizations that can leap over such organizational hurdles are usually those that deliver a high quality and value-added product. It is the very essence of improving information flows to the market.

A Not-So-Parallel: The Underwriting Industry and the Ratings Agencies

We would guard against taking seriously the market disruption line of reasoning, and would point to the evolution of the corporate debt underwriting industry itself for a guide. There were predictions of doom by the securities industry well over a decade ago when the commercial banks started their concerted moves into the traditional underwriting businesses.

They were playing an old but transparent game of the fear of the unknown. The incumbent securities firms were looking to stave off competition and thought predictions of chaos and trouble might strike a nerve. Having worked at one of those securities firms that was part of the entrenched bulge bracket working overtime to keep out the large banks, it in retrospect can be seen for what it was. The same was true of the banks that wanted to keep the brokerage firms out of commercial lending.

Despite prediction of disruptions then, the opposite came to pass. Now investors and issuers have much more choice of who they want to deal with, pricing is more competitive, the markets are more efficient and despite some bumps the system is

stronger and better capitalized. The bad old days of 1990 and 1991 were very scary times. The system handles shocks much better now even in volatile times. The innovation in such areas as the securitization markets, risk management tools in increasingly complex markets, and a broader array of financing options for global issuers has served the U.S. corporate sector well. It is in no small part due to the evolution of the banking and underwriting industry from a small group of a half dozen bulge bracket investment banks to a global bugle bracket of a few dozen major integrated financial service operations. The evolution of the credit markets was about letting competitors compete—and across highly regulated markets no less—and seeing the market benefit from innovation, competition and choice.

The ironic part of the story is that along the way, Moody's and S&P have been able to hitch a ride to the sweeping benefits that came with this intensified competition. Opening up the underwriting markets and allowing competition to flourish put a lot of money in the rating agency pockets. After all, new ratings firms were essentially blocked by a regulatory system that kept market entrants out while not holding the incumbents accountable. In other words, competition brings positive results for the market and the NRSRO's win. All in all it was a very sweet deal for the agencies. Wall Street, the investment banks and the securities firms invent new securities and engage in brutal competition to market them. Then Moody's and S&P come in and rate it and reap the benefits of inelastic pricing and no choice.

It is more than ironic that now Moody's and S&P wave the same red flags around market disruptions and hidden risks lurking around the corner that will create problems in the markets. Ignoring those false prophesies last time around in the banking and securities business brought the credit rating agencies windfall profits. We would highlight that their take on the risks sounds a lot like what the investment banks were crying about when the commercial banks and non-U.S. banks came into their space. It is an old ploy and one that has been proven without foundation on multiple occasions. In the case of the banks and brokerage houses, the system in the end benefited, and innovation was everywhere.

The NRSRO Concept

While critical of how the agencies have performed and used their special rights and privileges as an NRSRO, we still endorsed the concept of the NRSRO in our March 20, 2002 testimony before the Senate in the Enron hearings and again as part of the SEC Hearing on the Ratings Agencies on November 15, 2002. We again testified at the Congressional field hearings on the topic this past fall, and it now appears that the first meaningful action could be taken in 2006. Our endorsement of the NRSRO concept in those hearings was more a reflection of the critical role that such ratings providers play in the capital markets, and the need for a regulatory "bar" to clear for such agencies given their extremely important function.

As with most of the market practitioners that are accustomed to regulation, approval of some variation of the NRSRO concept implies regulation. The only problem is that Moody's and S&P believe they can never be regulated. So while Moody's and S&P say those that support some NRSRO framework agree with them, it is a matter of interpretation and could be argued most disagree. The agencies are quick to endorse an approval of the concept of some regulatory framework with an approval of their performance. That is hardly the case. In the past we have endorsed the NRSRO concept or some variant of that framework for the very simple reason that the rating agencies are in fact a major factor in the markets and heavily influence the behavior of securities, the cost of capital for issuers, and even the ability to gain market access. That is a lot of power, and that makes the NRSRO's the most powerful unregulated force in the market.

We are not unlike many of the major institutional clients that we speak with who are very frustrated with the lack of options and frequently questionable quality of rationales and analysis of risks. Default histories are very important in the analysis of track records of rating agencies, but so is the manner in which they explain evolving short-term risks from structural risks to potential volatility in an issuer's recovery risks. Many major investors are concerned over the outsized influence two dominant agencies can have on the behavior of securities in the markets. It is a parallel to having only a few market makers in the over-the-counter debt markets. More opinions and high quality information flows can smooth that effect and lead to fewer market distortions, just as we have seen in the debt markets themselves with more capital committed by more banks over the past two decades—even as the ratings business stood still structurally. We frequently hear of the lack of options and that there is a requirement to purchase more of the agencies various products because investors see them as so dominant and thus "have to." While the agencies have represented the dissemination of their ratings as free, their services are in fact very expensive to purchase.

In endorsing the NRSRO concept in the past, we had also clearly stated that the agencies were in need of some increased regulatory oversight that the current system did not provide. Despite the NRSRO's calculated and tactical strategy of stating that they play the role of "journalists" for purposes of their legal strategy to avoid any regulation, the NRSRO's very much in form, substance, and in execution play the role of a critical part of the underwriting process in all areas except liability, due diligence requirements, professional certification, and accountability. Any other party involved to such an extent in the underwriting chain has at least some checks and balances in place by the SEC or the NASD in the domestic markets—or at least face some accountability under the Securities laws.

All Congress has to do is to get the incumbent NRSRO's to admit that they are an integral part of the underwriting process and therefore subject to some regulation. After all, every other party remotely tied to the underwriting process is subject to some checks and balances from sell-side underwriters to secondary market makers. If they are not inextricably part of the underwriting process, it will be news to the market and probably the underwriters.

The First Amendment Strategy

At CreditSights, we see ourselves as also benefiting from First Amendment protection, and we have always been told when we were in the brokerage business at former employers that such rights would be used at least in part in any litigation. Then again, we never were of the impression that First Amendment rights were incompatible with the regulation by the NASD or the SEC that most of our research professionals have been accustomed to through their careers. We do not view regulation under either framework as particularly onerous and in fact just a normal cost and basic responsibility of doing business. The vehement opposition of the NRSRO's to any similar oversight is out of line with their actual role in the process.

As Moody's and S&P move closer to being in the buy-and-sell research business and engage in more market-based analysis, we find their ability to press on with the "we are journalists" shell game as borderline insulting to the many analysts that routinely take licensing examinations, work hard to gain professional credentials from the NASD or FSA or who take additional professional education measures such as the CFA. As of right now, the rating agencies have zero professional requirements, in stark contrast to every party along the underwriting chain from the securities industry employee to the CPA and lawyer in the process. It is probably also thus not a major surprise that their margins are also a lot higher.

The NRSRO's have devised a business strategy where they cite journalistic immunity from any oversight and all the while riding along the revenue coattails of the necessarily regulated underwriting and market-making service providers and with the NRSRO role a de facto requirement in the process. If the policy decision is to let such inequities continue, then at least allow some meaningful price and product competition to come into the picture on this very sweet deal. We do not doubt the ability of the highly profitable NRSRO's to buy the best legal opinions money can buy on the topic, but most of the constituencies in the debt markets see it for what it is. As some other legal commentators have pointed out in the past, if the agency rationale holds water, why not eliminate all oversight of research by the NASD as well?

The IOSCO Voluntary Framework and the Parallels to the U.S. Markets

Moody's and S&P point to the voluntary framework of the IOSCO as the template for how this should be handled. In other words, they want no change. In the end, it is not the IOSCO that created the most innovative and deepest capital market in the world. That was done here in the United States with the market forces being allowed to work. Then again the IOSCO also did not create the regulatory quagmire that has evolved out of the NRSRO system. That was created here also and needs to be fixed here.

The far less developed markets in the international credit space also are still largely dominated by large banks, securities houses, and sophisticated institutional investors. The U.S. market is much more advanced in the disintermediation process and relatively more is held at the retail and individual level indirectly through mutual funds and pension funds or directly in individual portfolios. Thus the parallel to the IOSCO is not a great one in terms of what is at risk, and the stakes are higher here. Leaving a partner monopoly in charge of their own policing might not be the most prudent of approaches anyway.

Light-handed regulation does not mean micromanaging the credit ratings process, but the credit ratings industry has never been given the opportunity to evolve the way the banking system has grown up the past two decades. It is time the ratings industry was allowed to catch up with the markets. The NRSRO's enjoy their

unalienable right to mail issuers a bill for the innovation the agencies have not driven. The policy objectives should keep in mind that such innovation came out of markets that have real competition. That lesson should not be lost in the rating agency reform process.

PREPARED STATEMENT OF VICKIE A. TILLMAN

EXECUTIVE VICE PRESIDENT, CREDIT MARKET SERVICES, STANDARD & POOR'S

MARCH 7, 2006

Mr. Chairman, Members of the Committee, good morning. I am Vickie A. Tillman, Executive Vice President of Standard & Poor's Credit Market Services, which includes Standard & Poor's Ratings Services (S&P), the unit responsible for assigning and publishing credit ratings of issuers and securities. Last year, our President, Kathleen A. Corbet, appeared at a hearing before this Committee and, on behalf of S&P, I welcome the opportunity to appear again to discuss the important role of credit rating agencies in the capital markets, and to address questions that have been raised about that role by Members of this Committee and others in Congress. In this testimony, I will address four broad topics:

- The origins and role of the NRSRO system;
- Steps that can be taken to increase the level of competition among credit rating agencies in the marketplace;
- Perceived conflicts of interest, such as those said to arise from the "issuer pays" model, and how they are effectively managed and disclosed; and
- the absence of need, as S&P sees it, for increased regulatory oversight of rating agencies and the credit rating process.

We have conferred extensively with Congress, the SEC, and global regulators on these issues and I look forward to sharing our thoughts on them with you today. Our over all view is that steps should be taken promptly to increase competition in this area—steps already identified by the SEC—and that recently enacted positive initiatives, as described below, should otherwise be given a reasonable time to work. This position reflects the views expressed by market participants in comment letters, surveys, and other forums. Before turning to these topics, however, I would first like to provide some background information about S&P and our credit rating business.

Background on S&P and the Nature of Credit Ratings

S&P, which is a part of The McGraw-Hill Companies, Inc., began its credit rating activities 90 years ago, in 1916, and today is a global leader in the field of credit ratings and risk analysis, with credit rating opinions outstanding on approximately 200,000 issues of obligors in over 100 countries. Over that time, S&P has established an excellent track record of providing the market with independent, objective, and rigorous analytical information in the form of credit rating opinions. A rating from S&P represents our opinion, as of a specific date, of the creditworthiness (that is, the likelihood of default) of either an obligor in general or a particular financial obligation. Once published, we monitor ratings on an ongoing basis. Our credit rating opinions, however, are neither recommendations to buy, sell, or hold a particular security; comments on the suitability of an investment for a particular investor or group of investors; personal recommendations to any particular user; nor investment advisory in nature.

At S&P, independence, transparency, credibility, and quality are the cornerstone principles of our business and have driven our long-standing track record of analytical excellence. Studies on rating trends have repeatedly shown that there is a clear correlation between the initial rating assigned by S&P and the likelihood of default: The higher the initial rating, the lower the probability of default and vice versa. In our most recent study of defaults, which we published just last month, we found that during the 5-year period from 2001 through 2005, of those companies worldwide that were rated investment grade by S&P, only 1.95 percent defaulted. The comparable rate for noninvestment grade companies was 24.36 percent. Moreover, of the 67 rated companies that defaulted in the last 2 years, no investment grade issuers defaulted in calendar year 2004 and only one issuer that had an investment grade rating at the beginning of the year defaulted in 2005.

In order to prepare and publish our ratings, we review a substantial amount of business and financial information about issuers and issues. The primary informational component is the public information available about an issuer, including the issuer's audited financial statements. S&P also takes into account additional infor-

mation that may be provided by the issuer, as well as other economic, financial, and industry information that our analysts deem appropriate. We are not auditors, however, and are not in a position to verify information provided by a rated company or its auditors. Instead, S&P expressly and necessarily relies on rated issuers to provide timely and accurate information. If an issuer refuses to provide requested information, S&P may, depending on the circumstances, issue a lower rating, refuse to issue a rating, or withdraw entirely an existing rating.

Once a rating is determined, S&P disseminates it to the public for free by, among other ways, posting it on our website, *www.standardandpoors.com.* Along with the rating, we frequently publish a narrative rationale authored by the lead analyst. The purpose of this narrative is to make the key bases for S&P's analysis transparent to the marketplace. When a rating change is anticipated or occurs, our analysts similarly report on the change and the rationale for it. At S&P, we have a long-standing policy of making our public credit ratings and the basis for those ratings broadly available to the investing public as soon as possible and without cost. Public credit ratings (which constitute 99 percent of our credit ratings in the United States) are disseminated via real-time posts on our website and through a wire feed to the news media as well as through our subscription services.

The corporate scandals of the last few years, many of which arose from the criminal behavior of senior management at large corporate entities, have demonstrated the importance of issuers providing accurate and reliable financial information to the marketplace and to rating agencies. Like many other market participants, S&P was misled by the conduct of some of these entities that set out to deceive it and other rating agencies.[1] We believe that the initiatives enacted by Congress and the SEC to improve the quality, transparency, and timeliness of disclosures by public companies as well as recent accounting standard initiatives, will enhance our ability to provide the market with credible and independent analysis.

We have also conducted our own review of the events of the past few years, a process consistent with our tradition of self-evaluation and our continuing efforts to ensure the independence and rigor of our ratings process. To meet the evolving needs of the capital markets, we have undertaken a variety of initiatives, including measures to enhance our analytic process, strengthen the training of our analysts and increase the effectiveness of our communications with the marketplace. For example, last year, in addition to a number of specialized analytical enhancements, we initiated a process for gathering formal market feedback on certain criteria and policy actions, allowing us to incorporate the market's input into our decisionmaking on those fronts. We have increased our mandatory training requirements to include training targeted toward our Code of Conduct and our policies regarding roles and responsibilities. In addition, last month we published a report describing the ways that we implement and monitor compliance with our Code of Conduct.

The marketplace has expressed support for these and similar constructive steps. For example, in a recent survey of fixed income investors by *Institutional Investor,* 83 percent of those surveyed said their confidence in rating agencies was the same as or greater than it was in the period before Enron's collapse. Similarly, Standard & Poor's Global Fixed Income Investor Survey, completed just last month by an independent third party firm, concluded that approximately 92 percent of investors feel that the rating agencies as a whole are doing the same or a better job today than they were 3 years ago. A recent survey by the Bond Market Association likewise found that more than half of the issuers and investors surveyed feel that rating agency transparency has improved in recent years and that over two-thirds of investors are satisfied with the quality of ratings.

S&P has also actively participated with the SEC and other regulatory and quasi-regulatory bodies around the world in their reviews of credit rating agencies and the ratings process. Because the value of credit rating opinions ultimately depends on their utility to the market, we have repeatedly expressed, in our work with the SEC and others, the continuing importance of a regulatory framework that recognizes the market—*that is,* the users of credit rating opinions—as the best judge of a credit rating agency's integrity, independence, objectivity, credibility and quality.

---

[1] In the Enron case, for example, key executives have admitted their part in a deliberate effort to mislead the rating agencies, including S&P. S&P's primary contact at Enron, Timothy Despain, has stated in his guilty plea that "[f]rom 1999 through the fall of 2001, in my capacity as Assistant Treasurer, I was directed by my superiors to engage in, and I did engage in, conduct that I recognized was intended to manipulate fraudulently Enron's credit rating, which rating I knew was relied on by the holders and prospective purchasers of Enron's publicly traded stocks and bonds." Similarly, Enron's former Chief Financial Officer, Andrew Fastow, has declared in a sworn statement that "[o]ur purpose was to mislead investors and others about the true financial position of Enron and, consequently, to inflate artificially the price of Enron's stock and maintain fraudulently Enron's credit rating."

It is in that same spirit, and for the purpose of advancing those same goals of independence, objectivity, credibility, and quality, that S&P welcomes the opportunity to appear before the Committee today.

The NRSRO System

The NRSRO concept was first introduced by the SEC in 1975. Although S&P did not affirmatively seek it, S&P was among the initial designees and has retained that status ever since. The initial designation reflected the broad market recognition that S&P had built up over the years for independent, objective, and credible ratings. Contrary to the suggestions of some, the NRSRO designation alone did not confer on S&P a prominent place in the capital markets, but rather recognized that S&P had, through its own efforts, already achieved that position.

Today, the NRSRO system is an integral part of the capital markets and regulatory landscape in the United States. In designating NRSRO's, a primary factor considered by the SEC has been the acceptance of a rating agency's ratings in the marketplace. Over the years, Congress, State legislatures, and other regulators have come to incorporate NRSRO ratings into a variety of regulations, including ones limiting the types of securities in which certain investors are permitted to invest. For example, in response to the savings and loan scandal of the late 1980's, Congress turned to the NRSRO system with respect to investors who had deposited funds in savings and loans. In amending the Federal Deposit Insurance Act, Congress generally proscribed savings and loans from holding non "investment grade" securities. *See for example,* 12 U.S.C. § 1831e(d)(1) (in relation to State savings associations). "Investment grade" securities, in turn, are defined as securities rated in one of the four highest categories by at least one NRSRO. *See* 12 U.S.C. § 1831e(d)(4)(A). Similarly, a number of States have adopted regulations regarding the retirement funds of State workers that limit the types of investments pension funds can make to those of a certain quality or risk profile. The benchmark often used in these types of regulations is whether the securities, or the entities issuing them, have investment grade ratings from an NRSRO.

The NRSRO system therefore serves an important function in the regulatory landscape that is not otherwise available. Doing away with that system without a suitable replacement, or substituting for the NRSRO system one in which savings and loans, pension funds, and the like are freed from the limitations imposed on them by Congress and the States, would leave a regulatory vacuum that could expose investors to unwarranted risks. Accordingly, we at S&P believe that, while the NRSRO designation process should be more open and streamlined, abandoning the NRSRO system would be a disservice to the very people and markets Congress and other regulators have sought to protect.

Moreover, this position reflects the market's views. For example, when market participants were asked, in connection with the SEC's 2003 Concept Release, whether the NRSRO framework should be retained, a vast majority said it should. According to the SEC, investors, trade associations, ratings agencies, and other market participants, "generally represented that, among other things, eliminating the NRSRO concept would be disruptive to the capital markets, and would be costly and complicated to replace." Indeed, only 4 out of 46 commenters supported elimination of the NRSRO system.

Competition Among Rating Agencies

While the NRSRO system is an integral part of the capital markets, it can be improved. For instance, some have recently expressed concern about the level of competition in the credit rating industry and the process by which NRSRO's are designated by the SEC. Broadly speaking, these concerns center around the fact that there are currently five NRSRO's; that the NRSRO designation process is perceived to be opaque; and that barriers to entry are considered too high. S&P shares these concerns. We have repeatedly and publicly supported a more transparent NRSRO designation process, the lowering of barriers to entry into our industry, and the designation, under clear standards, of new NRSRO's—all of which will engender increased competition.

The question is how to achieve those goals. In our view, the most sensible and least disruptive approach is to improve on the NRSRO system by having the SEC adopt a more inclusive, transparent, and streamlined NRSRO designation process—not to tear down a system that has worked well for decades. The groundwork for this process already exists and S&P encourages the Committee, the SEC, and others to help spur the effort toward successful closure.

Specifically, the SEC has already published and received comments on a proposed rule (the Proposed Rule) that, with certain modifications, we believe would address many of the concerns raised about competition in our industry. Among other things,

adoption of the Proposed Rule—which grew out of a 2003 Concept Release by the SEC—could increase competition among rating agencies and streamline the NRSRO designation process by:

- clarifying the criteria considered by the SEC for designation;
- formalizing the process for application and designation, including fixing a time period for the SEC to issue a decision on a rating agency's application for NRSRO status;
- allowing for designation of rating agencies that specialize in a particular industry or have prominence in a particular geographic area, thereby expanding the pool of possible designees; and
- providing a market-based means for applicants to meet the "general acceptance" criteria in instances when users attest to the reliability of a firm's ratings.

During the comment period in mid-2005, investors, issuers, and rating agencies alike expressed broad support for the Proposed Rule. We at S&P were encouraged by the proposal because it addressed concerns about transparency and competition but stopped short of calling for intrusive government oversight over the formation of rating opinions. Specifically, as we stated in our comment letter to the SEC, while we have some concerns over particular provisions in the Proposed Rule, our overall view was then, and remains today, that the Proposed Rule is an important step toward "increasing the transparency of the NRSRO designation process and reducing regulatory barriers to entry while, at the same time, ensuring that the capital markets remain the ultimate arbiter of the credibility of the ratings process." Notwithstanding support for the Proposed Rule from all corners of the capital markets and the fact that the Proposed Rule was drafted by the SEC itself, the SEC has taken no steps since the close of comments last June toward finalizing it.

The SEC's inaction is unfortunate because we believe the market would benefit from finalization and adoption of the Proposed Rule. Accordingly, we urge Congress to press the SEC to move forward on the Proposed Rule, rather than to adopt a legislative overhaul of the NRSRO system. While we support a more transparent and streamlined NRSRO system, any legislative or regulatory scheme that compromised the quality protections provided by the NRSRO system merely for an increase in the quantity of designated rating agencies would be a disservice to investors as well as the market. That is why we support an approach that would work within the current framework, but would promptly open that framework up to more qualified rating agencies in a manner that is both transparent and effective. The finalization and adoption of a modified version of the SEC's Proposed Rule in our view would do just that.

Perceived Conflicts of Interest

The market has accepted the long-standing, global practices of S&P and others to charge issuers or the agents rating fees. Despite this broad acceptance, some have raised concerns about potential conflicts of interest with regard to the effect of this model on the independence and objectivity of ratings. We believe these concerns to be unfounded. First, the current issuer-pays model provides a number of benefits not available under other models. Additionally, numerous studies have found that any potential conflicts of interest attendant to that model either have not materialized or have been effectively managed.

The benefits of the issuer-pays model should not be underestimated. The most salient and important of these benefits is that the issuer-pays model allows S&P and other rating agencies to publish their ratings and analysis free of charge to investors and others around the world in real time. In other words, it promotes the broad and free dissemination of important information to the marketplace quickly. Rating agencies can do this because the substantial costs inherent in gathering relevant information, reviewing it, analyzing it, forming opinions about it, and preparing and publishing ratings are covered by the fees charged to issuers. In the same vein, the issuer-pays model allows S&P and other rating agencies to perform ongoing surveillance (*that is,* continued monitoring of rated issuers after the publication of a rating).

While the issuer-pays model may not be the only workable model, it is worth noting that these benefits may not be available under other models. For example, rating agencies whose only source of revenue is subscription fees generally limit access to their ratings to their subscribers. The free flow of ratings analysis to the marketplace is thus necessarily more limited under a subscription-only model than under the issuer-pays model.

Another major benefit of the issuer-pays model is that it promotes market scrutiny of a rating agency's performance and credibility. This is a natural consequence of the open-ended nature of that model. Today, anyone anywhere in the world can

access, evaluate, and, yes, criticize our ratings opinions on the approximately 200,000 issues of securities in more than 100 countries, including approximately 99 percent of debt obligations and preferred stock issues publicly traded in the United States, that are available for free on our website. The market has no similar basis for evaluating the broad performance of rating agencies that use a subscription-only model because those rating agencies do not typically make their ratings public. Accordingly, we believe that constant market scrutiny is a key component of our drive to meet, and our success over the decades in meeting, the highest standards of objectivity, credibility, and independence.

Against these demonstrable benefits of the issuer-pays model stand the assertions of some that the model compromises the objectivity of published ratings. Respectfully, that is just not so. Market participants have made overwhelmingly clear that in their view no such compromises have occurred and effective safeguards against them are in place. For example, the SEC's January 2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," found that a wide-range of participants in two public hearings generally "did not believe that reliance by rating agencies on issuer fees leads to significant conflicts of interest, or otherwise calls into question the overall objectivity of credit ratings." The SEC reported that most hearing participants were of the view that any potential conflicts from the issuer-fee model are "manageable and, for the most part, have been effectively addressed by the credit rating agencies[.]" Some of these commenters pointed to the internal policies and procedures of rating agencies for guarding against conflicts of interest, while others believed that rating agencies such as S&P rate so many issuers and securities that they are not dependent on, and thus not beholden to, any one issuer. These types of comments from market participants have been repeated again and again, including in the *Institutional Investor* survey mentioned earlier in which 87 percent of those surveyed felt that any conflicts of interest arising from the issuer-pays model were either manageable or not a conflict at all.

The fact that rating agencies such as S&P have been able to protect against conflicts of interest should come as no real surprise. The hallmark of S&P's success in the markets and of our prospects for future success is our reputation for independence and objectivity. Without that reputation, S&P could hardly have achieved its place as one of the world's most respected credit rating agencies and we have every incentive to preserve it. If the market perceived that the opinions of S&P or any other rating agency were compromised by the influence of issuers or some other conflict of interest, the agency's reputation (and thus its bottom line) would inevitably suffer to a far greater degree than any benefits that come from the fees from specific issuers. This is particularly so given that no single issuer accounts for more than a negligible percentage of S&P's ratings-related fees. This fundamental dynamic has been widely noted by market participants and academics alike. In a December 2003 study, two Federal Reserve Board economists concluded after intensive study that S&P and other rating agencies consider their reputations in the marketplace to be of "paramount importance" and, in fact, are "motivated primarily by reputation-related incentives."[2] These conclusions comport with our experience that most issuers feel their ratings are too low, not too high, and thus, at least to them, the issuer pays model certainly does not slant a rating agency's analysis.

To further ensure that credit rating opinions are not influenced by the fact that S&P is paid fees by issuers, we have in place a broad infrastructure of policies, procedures and structural safeguards. For example, rating opinions are assigned by rating committees, not by individual analysts. We also have policies restricting analysts from participating in the marketing or solicitation of ratings services. Nor is analyst compensation based upon the ratings assigned to issuers they cover. Additionally, we have an Analytical Policy Board, chaired by S&P's Chief Credit Officer, which operates to monitor and ensure consistent application of S&P's criteria and methodologies and reviews and approves new criteria and methodology. We also disclose the fact that we receive compensation for our ratings in our publications and on our website.

S&P employees are also subject to our Code of Conduct as well as McGraw-Hill's Code of Business Ethics. These publicly available Codes establish strong standards to promote, among other things: (i) independence and objectivity in the credit rating process; (ii) honest and ethical conduct including minimization of potential or perceived conflicts of personal and professional interest; (iii) compliance with applicable governmental rules and regulations; (iv) protection of confidential information; and

[2] *See* Daniel M. Covitz and Paul Harrison, *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate,* The Federal Reserve Board Finance and Economics Discussion Series (December 2003), at 1, 3.

(v) the prevention of insider trading. These Codes also contain restrictions on personal securities ownership and trading designed to minimize any conflicts of interest in the conduct of the credit rating process and continued adherence to them is a condition of employment for our analysts. S&P also monitors the securities trading activities of its analysts. S&P believes that these measures, and others like them, have contributed, and will continue to contribute, to S&P's long-standing objectivity and independence and the market's perception of S&P as a credible provider of rigorous analytical information.

Another concern raised by some relates to the potential for conflicts of interest arising out of evaluation services by rating agencies, such as S&P's Ratings Evaluation Service (RES). An RES allows an issuer contemplating a particular transaction to present certain hypothetical scenarios to S&P for our review of the effects of those scenarios on that issuer's creditworthiness. Some have suggested that an RES is a consulting service and argue that a conflict of interest can result. This is not the case. S&P does not provide an issuer with advice as part of RES, but rather offers its opinion regarding creditworthiness under a hypothetical scenario. It is not a separate stand-alone activity, but part and parcel of the ratings process itself. For example, an issuer may request S&P to review the credit implications of a proposed acquisition before consummating the deal. While the final ratings decision for any RES-reviewed hypothetical that becomes reality is expressly reserved to the rating committee, S&P's receipt, in connection with the RES, of information about the proposed transaction beforehand (and our ability to conduct an informed analysis of it) not only provides valuable information to the issuer, but it also puts us in a better position to respond when the deal is actually announced. This enables us to provide the market with a more rapid analysis of the transaction, and allows the market to factor that analysis in more quickly. In light of these considerations, we believe that the concerns expressed by some regarding a potential conflict of interest related to these services are misplaced.

The Absence of Need for Government Regulation

Another topic that has received increased attention recently is whether Congress should pass legislation providing for greater oversight of rating agencies by the SEC. As you are aware, a bill was introduced in the House recently that would require, among other things, for all rating agencies to register with the SEC and submit to formal oversight. At S&P, we believe the historical absence of governmental regulation of our industry has fostered and promoted the independence of rating agencies that has served the market so well. The importance of that independence cannot be overstated. Ratings are opinions and analysts and rating committees must be free to form those opinions without fear of being second-guessed or subjected to rebuke for ratings that others might feel are either too high or low. Regulation calling for the SEC or some other government entity to assess that analytical process would necessarily involve such second-guessing and, we believe, cause analysts to be more tentative or conservative in their analysis so as to avoid later criticism. A tentative rating is not necessarily the same as the best rating and we are therefore concerned that increased regulation could actually lower, rather than raise, the quality of ratings analysis available.

Recognizing these considerations, the European Commission (EC), following a comprehensive study of the issue by the Committee of European Securities Regulators that included extensive input from marketplace participants, recently concluded that formal, government regulation of rating agencies was unwarranted. Instead, the EC determined that the markets would best be served by oversight of rating agencies based on their adherence to codes of conduct and the judgments of the market. This approach comports with the flexible oversight contemplated by the International Organization of Securities Commissions (IOSCO) in the model Code of Conduct Fundamentals for Rating Agencies it published in December 2004 after months of deliberation and an extensive market comment period. SEC Commissioner Campos, who also served as Chairman of the IOSCO Task Force, said that IOSCO's flexible approach would be "more effectively enforced" than a "universal code for all credit rating agencies to sign on to." Commissioner Campos explained that a degree of flexibility was appropriate because rating agencies vary considerably in size, business model and rating methods. S&P agrees that the market-based approach adopted by the EC and contemplated by IOSCO is the preferable oversight path as it is less likely to chill analysts from putting forth their best analysis and will not create regulatory barriers to entry for new participants. Such an approach is also consistent with marketplace views. For instance, when investors and issuers were specifically asked, as part of the recent BMA survey, if they felt additional regulatory intervention is required or desirable, only one in five investors and one in four issuers responded in the affirmative.

Over the last 2 years, we have been active in putting this market-based approach into action. For example, while S&P has had in place for many years a significant number of policies, procedures and structural safeguards, in September 2004, these policies and procedures were updated, aggregated into one document and released publicly in S&P Ratings Services' Code of Practices and Procedures, which itself was then updated in late 2005 into S&P Ratings Services' Code of Conduct. The Code of Conduct sets forth policies and procedures designed, among other things, to prevent any compromise in the ratings process from potential conflicts of interest, as discussed above. I have attached our Code of Conduct to my testimony as Exhibit 1. As previously mentioned, consistent with the IOSCO Code of Conduct, S&P has also published an implementation report in order to provide the market with greater detail about how S&P has implemented its Code of Conduct and our efforts at promoting compliance with that Code.

As the Committee is also aware, S&P and the other NRSRO's have been working actively with the SEC to adopt and implement a "Voluntary Framework for Rating Agency Oversight." The essence of this Framework is that each NRSRO would adopt, as S&P has already adopted, a Code of Conduct modeled on the IOSCO Code and would establish an independent internal audit mechanism by which it would test, on an annual basis, its compliance with its Code. The results, as well as any remedial measures, would be shared and discussed with members of the SEC staff.

These flexible, market-based initiatives avoid running afoul of the significant and long-standing constitutional protections afforded rating agencies under the First Amendment. Courts have repeatedly held that rating agencies are entitled to similar constitutional protections as, say, *The Wall Street Journal* or *BusinessWeek*. This is so because the activities of rating agencies are fundamentally journalistic: They gather information, analyze it, form opinions about it, and disseminate (that is, publish) those opinions to the public as credit ratings. Last year, in response to the introduction of a rating agency bill in the House of Representatives, our outside counsel prepared a memorandum discussing these constitutional protections and analyzing the constitutionality of that bill. I have attached a copy of that memorandum as Exhibit 2 to my testimony.*

The First Amendment confers legal protections that are essential to the ability of rating agencies to serve the markets broadly. Compromising these protections would not only have a chilling effect on the rendering of independent rating opinions, but, more fundamentally, would ultimately be to the market's detriment. Faced with the prospect of liability on the trillions of dollars worth of securities currently rated, the major rating agencies would necessarily have to scale back the scope of coverage provided as it would be impossible for them to continue to rate vast numbers of issuers and issues if they could be held liable whenever a rated issuer or issue defaulted. The capital markets would inevitably suffer as a result. This fundamental business reality, which underlies the First Amendment protections afforded rating agencies, has been recognized by courts, including the Federal court overseeing the multidistrict Enron litigation in connection with its dismissal of an Enron-related lawsuit brought against S&P and other NRSRO's.

A bill or regulatory regime that provided for stringent oversight, in our view, would also be counter-productive with respect to the quality of ratings. As it stands today, rating agencies may employ any number of approaches toward the evaluation of creditworthiness. Ratings are opinions and there is no "best" way to go about formulating them. A rigid oversight regime, with penalties for noncompliance, would incentivize firms to standardize their approaches, thereby deterring diversity and innovation in credit analysis. Such innovation is critical given that credit analysis methods must evolve over time in response to the growing complexity and variety of financial instruments that are rated.

These are some of the reasons why S&P opposes the legislation introduced in the House last summer and would likely oppose any legislation that called for a sweeping overhaul of our industry and regulatory oversight of the process by which ratings are generated and published. We believe that if such legislation were adopted, it would diminish the quality of ratings disseminated to the market and intrude on rating agencies' constitutionally protected editorial control.

Conclusion

We at S&P share the Committee's goals of increasing competition among rating agencies and lowering barriers to entry in our industry. We do not believe that a legislative approach to accomplish these goals is appropriate at this time. We do, however, urge the Committee to seek and, to the fullest extent possible, spur action from the SEC on its Proposed Rule. We also urge the Committee to take note of

---

* Held in Committee files.

the many constructive steps that have been taken by S&P and others in the industry (steps that have received a positive response from the market) and to consider the prevailing views of the marketplace on all of these issues, including the absence of evidence that potential conflicts of interest have had an effect on the objectivity of ratings. Legislation on this front is unnecessary; instead, the mechanisms that are already in progress both here and abroad should be given time to work. These mechanisms reflect the wisdom of the market and respect the constitutional protections afforded rating agencies that are vital to the important and successful role they play.

On behalf of S&P, I thank you again for the opportunity to participate in these hearings. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF FRANK PARTNOY

PROFESSOR OF LAW, UNIVERSITY OF SAN DIEGO SCHOOL OF LAW

MARCH 7, 2006

Thank you Chairman Shelby, Ranking Member Sarbanes, and Members of this Committee for the opportunity to testify today. I am a Law Professor at the University of San Diego, where I have spent much of the past 9 years studying the credit rating industry.

A Brief History

First, a bit of historical perspective. When I wrote my first academic article on credit rating agencies, in 1999, Moody's was not a public company and S&P was a relatively small line item at McGraw-Hill. I argued that the companies had an unfair oligopoly because of legal rules that required the use of NRSRO ratings. I also set forth evidence showing that credit ratings were "too little, too late," because they generate little information and lagged the market by months.

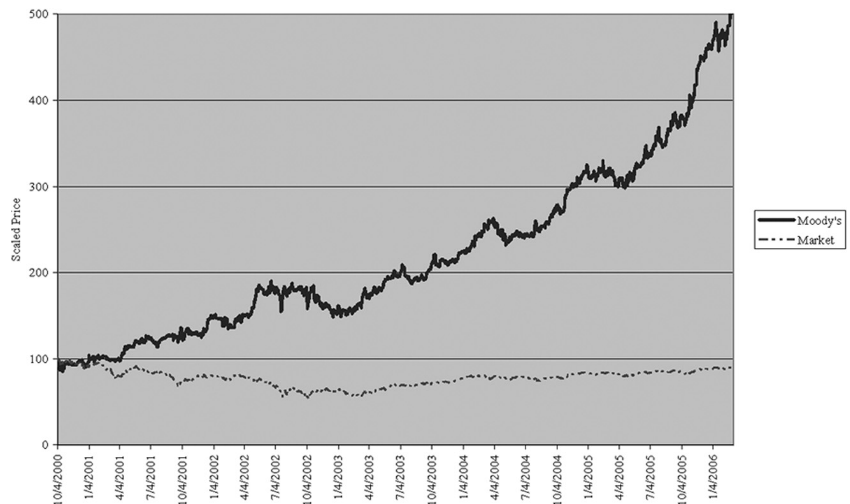
I did not expect much of a response—academic articles rarely generate interest. But the NRSRO's sent representatives to meet with me in San Diego and to dispute my findings at an academic conference. They also began a lobbying effort aimed at influencing opinion in the area. Moody's funded an academic research and advisory committee and even hired academics who had been examining NRSRO's.

Not much changed until Enron collapsed in late 2001. As evidence emerged that NRSRO's had played an important role, the U.S. Senate decided to examine the NRSRO process. When Senator Joseph Lieberman's staff invited me to testify before the Senate Committee on Governmental Affairs in January 2002, more than 4 years ago, Senators from both parties asked detailed questions about the serious problems and dangers in the credit rating industry.

Shortly thereafter, Moody's went public, with shares worth just about $4 billion, about one-seventh of the value of General Motors and less than half of the value of major financial firms such as Bear Stearns. Congress ultimately included as part of the Sarbanes-Oxley legislation a provision requiring that the SEC reexamine the NRSRO regime. I thank the Members of this body, and particularly Ranking Member Sarbanes, for doing so.

Today, we have the results of that investigation, and the evidence against credit rating agencies is damning. The problems I addressed in 1999 have multiplied exponentially, Moody's and S&P are more profitable and powerful than ever, and the dangers presented by the NRSRO system are much greater than they were in 2002. Moody's shares are now worth about $20 billion, more than those of either General Motors or Bear Stearns. As the chart below shows, Moody's shares have increased in value by more than 500 percent since they were issued, during a period when the rest of the market was down. (Similar data is not available regarding the market value of S&P, which remains a subsidiary of McGraw-Hill.)

Moody's vs. the Market



Key Problems

Moody's and S&P say they are merely publishing companies and that they distribute their to the public for free. But if that is right, why have they become so much more profitable?

Even a simple financial analysis shows that the NRSRO's are not in the publishing business. For example, Moody's shares are worth more than the combined value of Dow Jones (publisher of the *Wall Street Journal*), the *New York Times,* the *Washington Post,* and Knight-Ridder, which owns dozens of publications. But Moody's has only a fraction of those firms' employees, and provides far less information.

And credit ratings certainly are not free. The costs of ratings are passed to investors who buy rated securities, which are more expensive than they otherwise would be—by billions of dollars—because issuers are effectively required to pay for ratings.

The NRSRO's increasing oligopoly profits are a dangerous sign, a symptom of an infection spreading through the financial markets. Because regulations make NRSRO ratings so important, investors have incentives to engage in dysfunctional behavior to obtain high ratings. And they pay very high fees to do so. The rating agencies are conflicted, not only because issuers pay for ratings—but they also provide consulting services and threaten unsolicited ratings. The multi-trillion dollar credit derivatives industry, which is driven by NRSRO ratings and generates a large share of NRSRO profits, is opaque, volatile, and downright frightening.

Overall, the NRSRO regime poses a serious threat to the financial system. It is no coincidence that NRSRO ratings played a central role in the bankruptcy of Orange County, the collapse of Enron, and numerous other scandals.

Potential Reforms

In my view, the ideal solution would be to replace the entire NRSRO regime with one based on market measures. Every day, every hour, or even every second, the markets provide information about the risks of particular securities. Indeed, the NRSRO's use these measures (albeit not very well) in determining ratings. Congress might simply replace NRSRO ratings with reasonable market-based ranges. Alternatively, any reform, including the one set forth in H.R. 2990, would benefit from including market-based measures.

H.R. 2990 is a fair compromise. It would increase competition and create incentives for rating companies that use market-based measures and/or receive fees from investors, rather than issuers. Pressure from competition will vastly improve quality control in the credit rating industry. To the extent there are market-based constraints, they should eliminate any "race to the bottom." I have seen no evidence that opening the markets to competition would be disruptive or lead to rate shopping. Instead, it is the conflicts of interest and perverse incentives associated with

the current NRSRO system that pose the greatest concerns. It is possible that S&P and Moody's will continue to dominate the industry after reform, but if they do so it will be because they offer higher quality ratings in the face of competition, not because of a regulatory oligopoly.

Let me conclude by briefly mentioning three issues related to NRSRO accountability, which I believe should be part of the discussion of reform. First, Federal law currently exempts NRSRO's from liability for Federal securities fraud. It should not. Whatever one's view of securities fraud liability in general, there is no good reason to give NRSRO's special treatment.

Second, Moody's and S&P have claimed that their ratings are merely "opinions" that are protected as free speech. In my view, Congress should welcome S&P's threat to challenge the constitutionality of NRSRO legislation. If S&P did so, the Federal courts finally would be able to resolve this important issue, in a careful way with appropriate context. Credit ratings are not merely opinions, any more than fairness opinions of investment banks, audit opinions of accounting firms, legal opinions of attorneys, buy/sell ratings of securities analysts, or even the certifications of financial statements made by CEO's and CFO's are mere opinions. H.R. 2990 is not unconstitutional—if it were, then much of the Federal securities law system would be subject to challenges based on the First Amendment.

Third, the NRSRO's have argued that they can take care of any industry problems on a voluntary basis, perhaps with the help of the SEC. But both the NRSRO's and the SEC have demonstrated during the past three decades that they cannot be trusted to reform the credit rating business. The SEC created the regulatory oligopoly and the NRSRO's have exploited it. The SEC did not even attempt to define "NRSRO" until recently, 30 years after it first used the term. Documents such as S&P's "code of conduct" are self-serving and toothless. NRSRO's will not police their own conduct without a credible enforcement mechanism.

Our financial markets are the strongest in the world, in large part because Congress has intervened at critical moments to reshape the financial landscape. When the stock market crashed in 1929, Congress responded with important legislation, not just once but several times over a period of years. In 2002, Congress offered its first response to a wave of corporate scandals with the Sarbanes-Oxley legislation. Now is the right time for Congress to continue that response by acting to reform the crucially important credit ratings industry. Thank you again for the opportunity to give you my thoughts.

I have attached to this testimony my testimony on H.R. 2990, and three academic articles I have written on the NRSRO system.* I hope this information is helpful to the Committee.

PREPARED STATEMENT OF COLLEEN S. CUNNINGHAM

PRESIDENT AND CHIEF EXECUTIVE OFFICER

FINANCIAL EXECUTIVES INTERNATIONAL

MARCH 7, 2006

Thank you Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee for this opportunity to appear before you today.

My name is Colleen Cunningham and I am the President and Chief Executive Officer of Financial Executives International (FEI). FEI is the leading advocate for the views of senior financial executives, including CFO's, treasurers, controllers, and vice presidents of finance. Our members hold positions of critical importance to the financial stability of their companies, and take their responsibilities—to their employees, their shareholders, and their customers—very seriously. I am pleased to have the opportunity to share our views with you today on the important issue of credit rating agency operations and oversight. My remarks will largely focus on the importance of increased competition among credit rating agencies; the need for greater accountability for credit rating agency operations; and the importance of limiting—and possibly eliminating—potential conflicts of interest.

The Current Environment

Credit rating agencies (CRA's) play a vital role in the United States and world financial markets. There are more than 100 CRA's operating worldwide, but only five are designated as Nationally Recognized Statistical Rating Organizations (NRSRO's) by the Securities and Exchange Commission. They are: A.M. Best Co.

---

* Held in Committee files.

Inc.; Dominion Bond Rating Service Limited; Fitch Inc.; Moody's Investor Service Inc.; and the Standard & Poor's Division of the McGraw-Hill Cos. Inc.

These five enjoy a competitive advantage over their peers because the guidelines for many government, mutual fund, and other institutional investment portfolios not only specify minimum credit ratings for their securities but also require that the ratings come from NRSRO's. The SEC's unwillingness to designate more NRSRO's or to explain the designation criteria more clearly has left these incumbent NRSRO's with a distinct competitive advantage.

Currently, a CRA achieves NRSRO status be requesting a staff no-action letter from the SEC stating that the SEC will not recommend enforcement action against parties that use the CRA's credit ratings for the purpose of calculations under the SEC net capital rule for broker-dealers. The SEC's criteria for an NRSRO include that it be "widely accepted in the United States as an issuer of credible and reliable ratings." The notion of national recognition was designed to help ensure that the credit ratings used under SEC rules are credible and the marketplace can reasonably rely on them. Before issuing a no-action letter, the SEC conducts an assessment of a CRA's operational capacity and ratings process, including the CRA's organizational structure, financial resources, size and quality of staff, rating procedures, independence from rated companies, and internal procedures to prevent the misuse of nonpublic information.

Since NRSRO's were created in 1975, the importance of the NRSRO stamp of approval has grown far more than anticipated. Today, laws, charters, and by-laws often specify minimum credit ratings from NRSRO's for securities in pension funds, mutual funds, and other portfolios. State and local governments are usually required by law to invest in securities with specified ratings from NRSRO's. Mutual fund managers, to whom investors have entrusted over $8 trillion, typically rely on ratings from NRSRO's. Many of them incorporate NRSRO ratings criteria into shareholder disclosures regarding their funds' investment policies and strategies. Loan agreements often require borrowers to maintain certain ratings from NRSRO's; failure to do so can trigger higher interest rates, new bondholder rights, or even default.

The Need for Increased Competition

While the current system has afforded substantial advantages to the handful of CRA's receiving the NRSRO designation, it nevertheless has many shortcomings, not the least of which is limited competition. The two leading NRSRO's, Moody's and Standard & Poor's, dominate the credit ratings market, and have built formidable obstacles to competition: Their depth of staff, experience, and expertise in rating debt issuers worldwide remain unsurpassed. The large number of issuers they rate—and the long-term relationships they have established with these issuers—will make it extremely difficult for smaller CRA's to satisfy the "widely accepted" criteria necessary for NRSRO designation, which will in turn limit their ability to grow.

The most effective way to increase competition in the credit rating market would be to eliminate the broken "no action" process and replace it with transparent registration requirements which any credit rating agency can understand and aim for. By establishing stringent yet clear criteria for registration, Congress would not only ensure the continued validity of ratings issued by "registered" CRA's, but would also generate more competition in the credit rating market, which would in turn provide more choice for issuers; lower costs for rating services; and higher quality service.

The registration process itself should be straightforward. Congress should direct the SEC to begin by developing clear criteria for registration. CRA's could then apply, demonstrating in their applications and in supporting documents that they satisfy the criteria. The criteria might include: (a) demonstrating their procedures and methodologies used in developing ratings; (b) demonstrating that they have developed procedures for protecting nonpublic information; (c) demonstrating that they have developed procedures for addressing—and avoiding—nonpublic information; and (d) disclosing the qualifications of those tasked with developing ratings.

A recent FEI report entitled "Credit Rating Agencies: The Need for Increased Competition", written by Hal Davis, further elaborates on the importance of increasing competition in the credit rating market. I would ask that this report be included with my remarks in the hearing record.*

Accountability

Another problem with the current system is that there is no mechanism in place to ensure that NRSRO's continue to satisfy the criteria necessary to maintain the NRSRO designation. As previously mentioned, SEC staff currently consider two fac-

* Held in Committee files.

tors at the outset in determining whether a credit rating agency *qualifies* as an NRSRO. The most important factor is that the rating agency is nationally recognized as an issuer of credible and reliable ratings by the predominant users of securities ratings. The second factor is an assessment by the staff of the operational capability and reliability of each rating organization. This assessment covers six areas: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources; (3) the size, experience, and training of the rating organization's staff; (4) the rating organization's independence from the companies it rates; (5) the rating organization's rating procedures; and (6) whether the rating organization has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed.

While I applaud the use of transparent criteria to determine whether a CRA *qualifies* for special recognition or registration, I believe more emphasis should be placed on regular performance audits to ensure that registered CRA's *continue to satisfy* these criteria. Currently, once a rating agency has been designated an NRSRO, it is only required to notify the SEC when it experiences material changes that may affect its ability to meet any of these criteria. However, organizations such as rating agencies are constantly changing their business, not to mention their resources, procedures, and policies. And, given the enormous financial impact that a loss of NRSRO designation would have on a rating agency, it is unrealistic to expect NRSRO's to police themselves.

In addition to these regular performance reviews, I believe the CRA's should be required to disclose additional information about their operations as part of their registration application with the SEC. As has already been discussed, these disclosures could address such items as the CRAs' policies and procedures for protecting nonpublic information and for handling conflicts of interest; the training and experience of those individuals tasked with developing ratings; and the extent to which CRA staff met with an issuer's management prior to developing its ratings. This information would help investors differentiate between or among registered CRA's, and might help issuers decide which CRA to retain for rating purposes.

Accountability and transparency are vital components of any successful business operation, and in this instance I believe both issuers and investors would benefit by knowing that registered or recognized CRA's are required to maintain the highest operational standards through a process of regular performance audits.

Conflicts of Interest

Yet another flaw in the current system is that it fails to address the important issue of conflicts of interest. For example, some NRSRO's have sold fee-based, advisory services to their rated clients in areas such as risk management, corporate governance, shareholder disputes, and data analysis. The NRSRO's offering these services have offered assurances that they have erected adequate firewalls between their rating service and advisory service operations. While this may be true, issuers may nevertheless feel a subtle pressure to purchase advisory services to enhance the likelihood of receiving a good credit rating.

I believe that a simple, bright-line rule similar to the restrictions included in Title II of the Sarbanes-Oxley legislation would solve this problem. As this Committee well knows, Title II of the Sarbanes-Oxley Act addressed the issue of auditor independence, and enumerated specific activities which registered public accounting firms could no longer perform for their audit clients. This list included appraisal or valuation services; actuarial services; and legal service or expert services unrelated to the audit. I believe a similar line should be drawn here: Rating agencies should not be permitted to provide both fee-based, advisory services and rating services to the same issuer. This bifurcation of ratings services and advisory services should help ensure that credit ratings are developed and disseminated based solely on a companies' creditworthiness, and not on any unrelated matters.

In addition to this bright-line rule, rating agencies should be required to identify the types of potential conflicts of interest that arise in their businesses; their procedures for addressing and minimizing or avoiding those conflicts; and how they monitor and verify compliance with their procedures.

However, the rule described above should *not* prohibit preliminary rating assessments. In the regular course of doing business, issuers often hire rating agencies to analyze and explain the rating effect of taking on a certain amount of additional debt for a project or an acquisition. As a result, these preliminary rating assessments fall within the scope of credit rating services, and must continue to be available to those companies wishing to purchase them so they can succeed in the global financial marketplace.

Conclusion

The SEC has suggested that it is limited in its ability to oversee the work of the credit rating agencies because the Securities Act of 1934, which vests the SEC with its authority, does not specifically identify or discuss credit rating agencies. For this reason, I urge Congress to introduce legislation that addresses the three concerns I have discussed above: The need to increase competition in the credit marketplace; the need to increase accountability in CRA operations; and the need to eliminate conflicts of interest.

- Specifying the criteria by which CRA's can register with the SEC will almost certainly increase competition in the credit rating market. More firms, capital, and people will be attracted to the credit rating business. This would lead to greater innovation and new product introduction, providing issuers and investors with more choices.
- Increasing the accountability of the rating agencies through regular performance audits will ensure that registered entities continue to satisfy important operational criteria. These audits, along with increased disclosure requirements for various policies, procedures, and personnel qualifications, will help issuers and investors make more informed choices.
- Finally, prohibiting issuers from providing fee-based, advisory services to their rated clients will eliminate the potential pressure to purchase such services, and will also eliminate potential rating inflation for those companies that do purchase such services.

That concludes my remarks. I want to thank the Chairman and the Members of the Committee for inviting FEI to participate in today's hearings. We view credit rating agency oversight and reform as an exceptionally important matter, and appreciate having the opportunity to share our views. I would be pleased to answer any questions.

PREPARED STATEMENT OF DAMON A. SILVERS

ASSOCIATE GENERAL COUNSEL,

AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

MARCH 7, 2006

Thank you, Chairman Shelby and Ranking Member Sarbanes. My name is Damon Silvers, and I am Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL–CIO appreciates the opportunity to discuss the role credit rating agencies play in the debt markets from the perspective of America's working families who are looking to those markets to help fund their retirement, and their childrens' education.

Union sponsored benefit funds have over $400 billion in assets, and union members participate in benefit funds with over $5 trillion in assets. Most defined benefit funds have between 40 percent and 60 percent of their assets invested in fixed income investments. Individual union members, if properly advised, will shift the majority of their personal retirement savings into fixed income instruments as they approach retirement age, or will buy annuities from insurance companies rated by the principal credit rating agencies.

Union members' pension funds suffered substantial losses in both Enron and Worldcom bonds when those companies collapsed. Our funds bought those bonds with investment grade coupons relying upon the investment grade ratings they received from the rating agencies. We estimate the total losses to union members' funds from those two companies alone exceeded $35 billion.

Credit rating agencies are a vital part of the functioning of our capital markets. As one Moody's spokesperson has said, "our ratings are essentially a public good." The public good is the provision of reliable, easily analyzed credit quality data to all credit market investors that enable investors to quickly and efficiently make investment decisions without each investor having to determine for themselves the degree of risk involved in a given financial instrument. We believe the existence of credible rating agencies substantially contributes to the lower cost of debt financing compared to equity financing, with positive results for investors, entrepreneurs, and workers.

However, public goods are inherently delicate things—if not properly cared for they will vanish under the pressure of self-interested behavior by either their providers or their consumers. If credit agencies behave in a way that casts doubt on

the legitimacy of their ratings, the public good of cheap, reliable, and uniform data will be in jeopardy.

Credit rating agencies and their critics each have their case studies which either make the credit agencies into heroes or villains. We are less interested in this blame game and more interested in whether there are structural problems with the credit rating system. We begin by recognizing that the credit rating business is an effective duopoly, with the notable exception of the role A.M. Best plays in insurance markets. The Congressional Research Service estimates Moody's and Standard & Poor together account for 80 percent of the market.

Many have expressed concern about the level of concentration in the business of auditing public companies' financial statements. Obviously, the degree of concentration in the credit rating business is substantially greater—with two dominant firms and one subordinate firm, compared to four comparably sized major public audit firms and a substantial number of minor ones.

While there are benefits to having a limited number of well-regarded credit rating firms, the current degree of concentration appears excessive. Greater competition however is unlikely to be a sufficient solution to the structural problems with the credit rating business. This is both because the scale and prominence of the existing firms are a formidable barrier to entry and because the real customers are not doing the buying—and it is hard to see how they could without substantially detracting from the liquidity of the credit markets. In this respect as in many others the credit rating business has similarities to the business of public company auditing.

If greater competition is unlikely to be a sufficient solution, then there must be additional sources of accountability. In this respect, credit rating agencies are not all that different than other quasi-private entities that play important roles in our capital markets. These entities, the public company audit firms and the self-regulatory organizations, have suffered through significant crises of public confidence since 2001.

There are principles which the problems with financial market gatekeepers have brought to light. First, if there are institutions that are monopolistic and operate in markets where there are significant principal-agent issues, like auditors and credit rating agencies, there will be systematic abuses if there is not government regulation. We have seen in both the *Washington Post's* coverage of the rating agencies and in the Securities and Exchange Commission's examination of the same allegations of exactly the abuse one would expect to see—alleged differential treatment of firms depending on whether they paid rating agency fees, agencies engaging in consulting businesses that parallel their core ratings businesses, and lax treatment of major issuers like Enron, with devastating consequences.

Second, the regulation that is necessary must focus on three areas—monitoring the seriousness of agency reviews of issuers, preventing abusive business practices like coercing payments through bad ratings, and putting an end to conflicts of interest that lead rating agencies to become too cozy with the companies they rate. This is analogous to the bar on most auditor consulting services contained within the Sarbanes-Oxley Act and expanded on by the PCAOB.

While it is true that credit rating agencies, like audit firms, could make more money by selling consulting services to credit issuers, such conduct is really incompatible with the quasi-public mission they have been entrusted with, and the effective monopoly they have been granted.

We find the need for regulation particularly compelling in light of the existence of the Nationally Recognized Statistical Ratings Organization (NRSRO) concept in our securities laws. Currently we have essentially a federally protected duopoly whose participants are unregulated. That situation has and will continue to lead to abuses.

The NRSRO concept is helpful in dealing with information costs to investors, government agencies, and a wide variety of financial market actors. Replacing it with a mere registration process without substantive oversight, as some have suggested, will be harmful to investors and the ultimately to the functioning of our credit markets. However, the NRSRO system should be more transparent and open—so that firms that wish to become NRSRO's know what that entails and so that existing NRSRO's can be held accountable to clear standards.

For these reasons we would favor the regulation of the ratings agencies either directly by the Securities and Exchange Commission or by a PCAOB-like body, with the powers to set specific criteria for being recognized as a NRSRO, oversee agency practices, set positive standards and proscribe abusive practices. These were the recommendations of the Senate Committee on Governmental Affairs October 2002 report following the collapse of Enron. The SEC in its June 2003 concept release asked for comment on these concepts as well, but the Commission has taken no further action.

This Committee can be very proud of its work in crafting the Sarbanes-Oxley Act of 2002. That Act contains within it the principles that should be applied to the credit rating agencies—real independent oversight, and an end to conflicts of interest. Credit rating agency regulation is part of the unfinished agenda of corporate reform—like the reform of executive compensation that the SEC is now attempting, and the need to reform public company board elections that remains unaddressed. The AFL-CIO commends this Committee for taking up this issue and hopes that this unfinished agenda item can be finished. We appreciate the opportunity to appear before the Committee and look forward to working with you as you move forward.

PREPARED STATEMENT OF JEFFREY J. DIERMEIER, CFA

PRESIDENT AND CHIEF EXECUTIVE OFFICER, CFA INSTITUTE

MARCH 7, 2006

Introduction

Good morning. I am Jeff Diermeier, and I am the President and Chief Executive Officer of CFA Institute. I would like to thank Senator Shelby, Senator Sarbanes, and other Members of this Committee for the opportunity to speak to you this morning on this important topic.

First, some background about CFA Institute. CFA Institute is a nonprofit professional membership organization with a mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. We also fund and support the CFA Centre for Financial Market Integrity, which promotes high standards of ethics, integrity, and professional excellence within the investment community.

A common denominator for anyone involved with our organization is adherence to a Code of Ethics that I am comfortable calling the highest ethical standard that exists for investment professionals. Though adherence to the code is a requirement of being a member of CFA Institute, of holding the CFA designation, or of participating in the CFA Program, it is nonetheless a voluntary standard. That is, I am talking about a self-regulatory system.

For the record, CFA Institute is a staunch proponent of self-regulation. This approach is embodied not just in our Code of Ethics, but also in a number of additional guidelines and standards we have established in areas such as issuer-paid research and objectivity of analyst research. As I will discuss later, these standards might provide some good models for this Committee as it determines how to address the issues before you today.

In most cases, I believe that self-regulation is a preferred alternative to government-imposed regulation, which adds complexities and increases the costs of capital, which are ultimately shouldered by investors large and small. This, of course, is a view shared by regulators and standard-setters themselves, which is why we frequently have worked closely with these groups, including the Securities and Exchange Commission, to develop such standards.

However, a necessary prerequisite to self-regulation is that it must be embraced by the market participants whose activities it attempts to standardize. Such appears not to be the case with credit-rating agencies that have been reluctant to embrace any type of regulation over the services they provide to the investment community. This despite the fact that, from our viewpoint, their business model appears to have significant conflicts. In a business that relies upon public trust for its existence, credit-rating agencies should be held to the highest standards of transparency, disclosure, and professional conduct. Instead, there are no standards. There is no oversight. And, as a result, investors are left in the dark, with no assurance that their interests are being served.

We are glad to see that the Committee has listed as a priority for this second Session of Congress the need to address conflict-of-interest and competition concerns that have been raised about credit-rating agencies, as Senator Shelby announced on January 31.

Current Situation

The lessons learned from the crisis of confidence of the recent past should be clearly etched in our memory and should be part of the compass guiding policies to protect investors' interests and promote efficient, fair capital markets. It was a

crisis that reached into all segments of our industry and led to substantial reform throughout our financial system. Despite credit-rating agencies' enormous impact on the issuance of debt securities, influence on market prices, and, consequently, on issuers' cost of capital and ability to access capital, they have not embraced, nor are they covered by, the new regulatory controls.

- Were credit-rating agencies operating within an environment of openness and transparency of business practices, free from substantial conflicts of interest, your Committee might have been advised to leave them alone. Such is not the case.
- Their problems notwithstanding, if credit-rating agencies were willing to engage with regulators to address the variety of serious issues facing their business, it would have been reasonable for your Committee to let those discussions run their course. Such is not the case.
- Or if credit-rating agencies were eager to avoid regulation, but began serious dialogue about a self-regulatory system, there would be no need for this Committee to focus its attention on these issues. But such is not the case.

Instead, credit-rating agencies, a small group of firms with enormous impact on our capital markets, repeatedly have disputed the need for reform. Without clear disclosure of how they manage conflicts that appear to be inherent, we cannot know whether these conflicts put rating agencies' business practices at odds with the interests of the investing public.

What we hear from rating agencies when prompted with the idea of reform does not help matters. They state that theirs is not a product intended for use by investors and that their work should be protected under the First Amendment as "journalistic product." These viewpoints, I understand, perform well in the court of law, but they are not in alignment with the reality that investors do indeed rely on their services as an important tool in verifying the legitimacy of debt securities.

Rating agencies seem to want it both ways: They embrace the regulatory protection of NRSRO status and the regulatory requirement that debt issuers seek their services, but they reject any semblance of regulatory checks-and-balances on their business. They wish to continue to operate with no rules for disclosing the processes they use to assign ratings, which are, by all accounts, critical to a healthy capital-market system.

Others here today, I am sure, will delve more deeply into the conflicts and anti-competitive environment that surround credit-rating agencies. So, I will summarize what I see as the significant issues that must be addressed to provide some context for the proposals I will encourage the Committee to consider.

- Chief among the issues are conflicts of interest that appear to exist, notably that rating agencies rely so disproportionately on revenues provided from the issuers they rate. These conflicts are exacerbated by rating agencies pitching ancillary services to issuers, such as prerating assessments and corporate consulting. In these relationships, the rated company holds the cards, meaning it has the power to end a contract if and when the rating agency offers anything other than a glowing review. Rating agencies are under constant pressure to issue favorable reviews in order to retain a particular book of business. Further, agencies are under no obligation whatsoever to publish their findings. Negative reviews, therefore, may never make their way to the investing public.
- Under ordinary circumstances, competitive market forces might be capable of solving the problem: Those with reputations of full disclosure and investor focus could be expected to rise to the top. But, ironically, the one bit of authority the SEC does have is to require issuers of publicly traded debt securities to receive credit ratings from "Nationally Recognized Statistical Rating Organizations," or "NRSRO's." This has the unintended consequence of reducing competition since the threshold for a new entrant in the marketplace to achieve "nationally recognized" status is practically insurmountable. As a result, only five agencies hold this coveted status. In other words, even though rating agencies are not beholden to regulators, they nonetheless are beneficiaries of the rules that are in place for issuers. As the SEC itself noted in a rule proposal to change the definition of "NRSRO," greater competition could provide issuers with more choices, "which would lower their costs for this service. The greater competition in the market for credit ratings and analysis could provide more credible and reliable ratings. Greater competition also could stimulate innovation in technology and methods of analysis for issuing credit ratings, which could further lower barriers to entry."
- The SEC has attempted to work with rating agencies to expand the definition of "NRSRO" and to promote better standards and practices, but the rating agencies have stood together in rejecting the proposals.
- In Senate testimony a year ago, Annette Nazareth, then the SEC's Director of Market Regulation pointed to self-regulation as a potential solution. She said that

a "strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit-rating industry." But credit-rating agencies have rejected all such approaches, whether expansion of regulatory reach, imposed self-regulation, or voluntary self-regulation. They assert protection by the Fourth Amendment right against searches and seizures and, as previously mentioned, by the First Amendment right to free speech, arguing that credit ratings are essentially a "journalistic" product.

It is our belief that the standoff between rating agencies and the SEC is likely to remain unless Congress decides either to expand the SEC's oversight powers and/or to mandate rating agencies to submit to either involuntary regulation or voluntary self-regulation. We commend the Committee for your leadership in addressing this issue.

Proposals

Regardless of its form, if credit-rating agencies provide a service that relies on public trust—which we believe they do—it should be obvious, even to the strongest free-market supporters, that standardization must take place. Let me be clear that I am not talking about disclosure of methodologies used in rating companies or securities, but rather the development and enforcement of standards of disclosure and transparency, along with the development of accompanying codes of professional conduct that befit an industry that serves, and relies upon, the investing public.

Given the impasse that appears to exist between the SEC and rating agencies, we have a number of suggestions that we believe your Committee should consider as it determines how to address the current situation for the benefit of all investors.

- *First, the NRSRO definition is antiquated and must be revised.* The initial hurdle to become "nationally recognized" is high and has had the unintended consequence of reducing the ability of new entrants into the marketplace, placing an emphasis on "recognition" versus an emphasis on competence. No set of legislative or regulatory actions will be able to fully address the problems in this sector until competitive forces are allowed to flow. The mere fact that rating agencies are able to stand together in such uniform fashion to oppose even *self*-regulation should be a demonstration to the Committee that competition has been artificially stifled, ironically by an SEC-imposed rule intended to protect investors.
- *Second, regulatory oversight for credit-rating agencies should be assigned to the SEC and rating agencies should be subject to periodic SEC review.* Without adequate authority assigned to the SEC, any changes that rating agencies make—either voluntarily or by regulation—cannot be quantified or verified.
- *Third, I believe the situation we are talking about here with credit-rating agencies is materially similar to a situation we have dealt with in the area of issuer-paid research.* In this case, small companies that are not covered by Wall Street analysts pay firms to provide equity research. You do not have to dig deeply to see the conflicts here. To address these conflicts, CFA Institute and the National Investor Relations Institute partnered to develop best-practice guidelines for managing the relationship between corporations and financial analysts. I believe these guidelines, entitled "Best Practice Guidelines Governing Analyst/Corporate Issuer Relations," could serve as a model if and when standards for better managing the relationship between corporations and credit-rating agencies are developed. I have included a copy of the guidelines with my written statement and I call your attention specifically to page five of the document, which identifies specific disclosures, checks, and balances related to issuer-paid research.

  Another relevant situation of the recent past is the well-documented conflict that historically has existed between the investment-banking and research departments at brokerage firms. This, of course, had a multitude of consequences, most notably that analysts received pressure from both inside and outside their firms to issue favorable recommendations on the stock of current and potential investment-banking clients. In this case, CFA Institute developed Research Objectivity Standards to address the conflicts in the research process, which are not limited to equity research, but extend to fixed-income research and, as I have mentioned, credit ratings. The same disclosures and restrictions should be required of credit-rating agencies.
- *Fourth, an industry-wide standard of professional conduct should be developed that clearly defines standards of independence, appropriate relations between agencies and issuers, and duties to the investing public.* Analysts and supervisors should be required to attest annually of their adherence to the standard. In many cases, simply identifying the areas of conflict, and processes to eliminate or manage those conflicts, would be a big step forward, but annual attestation of adherence moves us to a higher standard.

- This code of conduct should required rating agencies to explain in their reports what analyses were performed in arriving at a particular rating and what factors were considered in preparing a credit rating. The current lack of transparency that is endemic among rating agencies must be addressed. No NRSRO standards currently exist for defining what minimal analyses should be performed in support of a credit rating. Until such standards are in place, investors can have little faith that any consistency exists in ratings of a firm or across firms in rating securities of similar characteristics and attributes.
- The code of conduct also should require NRSRO's to adhere to standards that govern the analyses performed. One of the simplest approaches would be to require that policies and procedures be established and verified to ensure compliance. These could include requiring documentation in support of the analyses as well as periodic supervisory review of the documentation and ratings. Management must have a specific accountability for these policies and procedures if meaningful change is to take place.
- Last, the code of conduct should establish minimum competency requirements within rating agencies for those who analyze securities and assign their ratings. Given the importance of the ratings in setting market prices and determining issuers' cost of capital, access to capital, and their effects on investors' wealth, verification of basic industry knowledge for those involved should not be a lot to ask.

Conclusion

As I stated earlier, CFA Institute is a proponent, whenever possible, for self-regulation over government-mandated regulation. Nonetheless, we recognize that self-regulation has its limitations and there comes a time when full-fledged regulation is the only course of action. Of all the directions this Committee has at its disposal, we believe the one direction it absolutely should avoid is the status quo.

The Code of Ethics I mentioned earlier to which all of our 80,000 members must abide requires them, above all else, to place the interests of investors first. And we believe that if this Committee, the SEC, and rating agencies are to follow that same principle, you ultimately will find the right solution. CFA Institute is committed to providing our perspective and any type of assistance to the effort.

PREPARED STATEMENT OF ALEX J. POLLOCK

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

MARCH 7, 2006

How to Improve the Credit Rating Agency Sector

Good morning, Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee. Thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views on the need to reform the credit rating agency sector.

It is important and timely for Congress to address this issue. There is no doubt that the existing SEC regulation and practice represents a significant anticompetitive barrier to entry in the credit rating business, although this was not intended when the regulation was introduced 30 years ago. Nonetheless, the actual result of the SEC's actions, and in recent years, inaction, has been to create what is in effect a government-sponsored cartel.

A few weeks ago *Barron's* magazine had this to say about the two leading rating agencies:

> Moody's and Standard and Poor's are among the world's great businesses. The firms amount to a duopoly and they have enjoyed huge growth in revenue and profits in the past decade.

Barron's continues:

> Moody's has a lush operating profit margin of 55 percent . . . S&P's [is] 42 percent.

An equity analyst's investment recommendation from last year explains the reason for this exceptional and enviable profit performance:

> Companies are not unlike medieval castles. The most successful are that boast some economic moat that makes it difficult, if not impossible, for competitors to attack or emulate. Thanks to the fact that the credit ratings market is heavily regulated by the Federal Government, rating agencies enjoy a wide economic moat. (emphasis added)

This is an accurate assessment.

I recommend that Congress remove such government-created protection or "economic moat," and promote instead a truly competitive rating agency sector, with all the advantages to customers that competition will bring, including better prices, more customer choice, more innovation, greater efficiency, and reduced potential conflicts of interest.

I believe that the time has come for legislation to achieve this.

Instead of allowing the SEC to protect the dominant firms (in fact, if not on purpose), in my view Congress should mandate an approach which is procompetitive and promarket discipline. Last year, the AEI published an article of mine (attached for the record)* entitled, "End the Government-Sponsored Cartel in Credit Ratings": I respectfully hope Congress will do so this year.

The "NRSRO" Issue

In the best theoretical case, not only the designation by the SEC of favored rating agencies, but also the regulatory term "NRSRO" would be eliminated. The term has produced unintended effects never imagined when it was introduced in 1975, and in theory it is unquestionably time for it to retire.

In its place, the responsibility to choose among rating agencies and their services should belong to investors, financial firms, issuers, creditors, and other users of ratings—in short, to the market. A competitive market test, not a bureaucratic process, will then determine which rating agencies turn out to be "widely accepted by the predominant users of ratings," and competition will provide its normal benefits.

This is altogether different from the approach taken in proposals by the SEC staff, which in my opinion, are entirely unsatisfactory.

Very much in the right direction is the bill introduced in the House by Congressman Michael Fitzpatrick, H.R. 2990.

This bill directly addresses the fact that a major practical obstacle to reform is that the SEC's "NRSRO" designation has over three decades become enshrined in a very large and complex web of interlocking regulations and statutes affecting thousands of financial actors. The combined effect is to spread the anticompetitive force of the SEC's regulation throughout the financial system, with too few customer alternatives, too little price and service competition, and the extremely high profits for the favored firms, as we have already noted. But how can we untangle this regulatory web?

As you know, H.R. 2990 does so in what I think is an elegant fashion by keeping the abbreviation "NRSRO," but completely changing its meaning. By changing the first "R" from "Recognized" to "Registered," it moves from a restrictive designation regime, to a procompetitive disclosure regime. This change, in my view, is in the best tradition of American financial market theory and practice: Competition based on disclosure, with informed investors making their own choices.

Voluntary Registration

Becoming an "NRSRO" is now, and would be under a registration approach, an entry into the regulated use of your ratings by regulated financial entities. Therefore I believe that registration in a new system should be entirely voluntary. If any rating agency wants to continue as simply a private provider of ratings to customers who make such use of them as they desire, other than regulatory use, it should continue as it is, with no requirement to register. But if it wants to be an "NRSRO," the way is plain and open.

I think this voluntary approach entirely removes the First Amendment arguments which have been made against H.R. 2990.

Rating Agency Pricing Models

An extremely important advantage of a voluntary registration, as opposed to an SEC designation, regime is that it would allow multiple rating agency pricing models to compete for customer favor. The model of the dominant agencies is that securities issuers pay for credit ratings. Some critics argue that this creates a conflict of interest.

The alternative of having investors purchase the credit ratings arguably creates a superior incentive structure. This was the original historical model for the first 50 years of the rating agency business. If investors pay, it obviously removes the potential conflict of interest and any tendency toward a "race to the bottom" in ratings quality.

---

* Held in Committee files.

In my view, there should be no regulatory or legal prescription of one model or the other: The market should use whichever credit rating providers best serve the various needs, including the regulatory needs, of those who use the ratings.

Transition to a New Regime

The decentralization of decisions entailed by a competitive, disclosure-based regime is wholly positive. Investors and creditors, as well as multiple regulatory agencies, should have to think about how credit ratings should be used and what related policies they wish to adopt. They should be expected to make informed judgments, rather than merely following an SEC staff decision about whether somebody is "recognized."

The worst outcome, to be avoided in any case, would be regulation of actual credit ratings by the SEC, or (what would come to be equivalent) regulation of the process of forming credit ratings. This would be a worse regime than we have now.

Of course, a fully competitive rating agency market will not happen all at once. There are significant natural (as well as the SEC's artificial) barriers to entry in this sector, including the need to establish reputation, reliability, and integrity; the prestige factor involved in the purchase of opinions and judgments; and the inherent conservatism of institutional risk management policies. Nevertheless, in time, innovation and better products can surmount such barriers, when not prevented by regulation.

Because the desirable transition to a competitive rating agency sector would be evolutionary, I believe any concern about disrupting the fixed income markets is misplaced.

It is important to remember that no matter what the rating agency regime may be, we simply cannot hope for 100 percent success in predicting future credit performance. There will never be a world in which there are no ratings mistakes, any more than in any other endeavor which makes judgments about future risks and uncertainties. But this fact only emphasizes the importance of a vibrant marketplace of ratings opinions, analysis, ideas, forecasts, and risk assessments.

On timing, the "NRSRO" issue has been a regulatory issue and discussion for a decade, in what seems to me a dilatory fashion. My recommendation is that Congress should now settle the issue of competition vs. cartel in this key financial sector, moving to create the best American model of competition and disclosure, rather than prescription and government sponsorship.

This will bring in time better customer service, more innovation, more customer alternatives, greater price competition, and reduced duopoly profits, and indeed better credit ratings will emerge.

Thank you again for the chance to be here today.